EMPLOYEE BENEFIT RULES

HEARINGS

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

WASHINGTON, DC, JANUARY 24, 25, AND MARCH 21, 1989

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EMPLOYEE BENEFIT RULES

TUESDAY, JANUARY 24, 1989

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to call, at 10:07 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LaFalce. The Small Business Committee will come to order.

I am Congressman John LaFalce, chairman of the House of Representatives' Small Business Committee, and it is my pleasure to welcome all the members of the Small Business Committee here today to their first hearing of the 101st Congress. We have not yet organized either the exclusive major or minor committees, and so we are proceeding a little bit faster than normal in having a hearing before reorganization. But because of the tremendous import of the issue we are going to be considering today, section 89, we thought we would have the hearing as soon as possible.

We will reserve for a later date the introduction of all the members of the committee, but we do have a number of new members here, members who did not serve on the Small Business Committee in the 100th Congress—as a matter of fact, did not serve in Congress before—and I wonder if they might introduce themselves briefly.

Mr. Hoagland. My name is Peter Hoagland, and I am from the second district of Nebraska, which is Omaha, and I am pleased to be here, Mr. Chairman.

Chairman LaFalce. Thank you.

Mr. Poshard. Thank you, Mr. Chairman. My name is Glenn Poshard, and I am from the 22d district in Illinois, which is the southernmost 22 counties of the State.

Chairman LaFalce. Thank you. We have some minority members here—at least one.

Mr. Hancock. My name is Mel Hancock, Mr. Chairman, and I am from the seventh district of Missouri.

Chairman LaFalce. Thank you very much. We welcome all of you to membership on the Small Business Committee, and we look forward to your contributions to its deliberations.

The committee has scheduled our hearings today and tomorrow to examine the impact of new employee benefit rules on small businesses and their potential effect on expanding health care coverage among employees of small firms.

Specifically, the hearing this morning will focus on section 89 of the Internal Revenue Code, which is intended to ensure that employer-sponsored benefit plans are broadly based and do not favor top-level employees.

Section 89, which was enacted as part of the Tax Reform Act of 1986, took effect on January 1 of this year. The new law requires all employers to conduct a series of tests to determine if their employee benefit plans, principally health and life insurance, are distributed fairly among their highly-paid employees and the rank and file.

It has been 2 years since enactment of section 89, but the Treasury Department has not yet issued regulations to provide formal guidance to employers on how to comply with its exceedingly complex testing requirements. The Assistant Secretary for Tax Policy requested a postponement of his appearance at today's hearing because those regulations are currently in the review process. We expect to call him at a subsequent hearing to discuss the new regulations and explain how they have attempted to minimize the compliance burden on small business.

I want to emphasize at the outset that I fully support the stated objective of section 89, which is to encourage employers to expand health insurance coverage among the working uninsured.

It is estimated that over 37 million Americans have no health insurance of any kind. Nearly half of the uninsured population, more than 18 million people, are workers. The vast majority of these uninsured workers are employed by small businesses. In fact, recent studies show that nearly half of all uninsured workers are employed in firms with less than 25 employees.

Obviously, this gap in health insurance coverage is a critical national problem and one which this committee has been addressing over the past 2 years. We held a series of hearings in the last Congress to discuss the obstacles small businesses face in providing health care benefits and to explore alternative strategies to expand health coverage among small employers. It is in this context that we begin this inquiry today on the potential impact of section 89 on the offering of health benefits by small business.

Our concern is based on the information we have received from individual business owners throughout the Nation, and from their small business associations here in Washington, that the likely effect of section 89 will be to discourage small employers from offering health coverage or to reduce the benefits they now provide.

Business owners will face costly data-gathering requirements and complicated valuation rules to test the eligibility and benefit provisions of each of their benefit plans. If a benefit plan fails the statistical tests required by section 89, highly-paid employees would be taxed on the value of the excess benefit they receive.

The extreme complexity of the law's benefits testing requirements, the costly administrative burden it imposes, and the lack of any formal guidance from Treasury make it very difficult, if not impossible, for employers to comply with the new law.

It is for that reason that I am today introducing legislation, with a bipartisan group of 35 cosponsors, to repeal section 89. I am doing so to give Congress an opportunity to review the impact on employers and to examine reasonable, rational, simplified alternatives to achieve the policy goals of assuring fair distribution of employee benefits and reducing the ranks of the uninsured. We will begin that process this morning. We will hear testimony from business owners and representatives of small business associations who will describe the difficulties they face in complying with section 89 and will, I hope, suggest alternatives.

Our witnesses are John Satagaj, president of the Small Business Legislative Council; James Lagos, president of National Small Business United; John Paul Galles, executive vice president of National Small Business United; Donald Corbett, representing the National Federation of Independent Business; and Diane Large, vice president for personnel at the U.S. Chamber of Commerce. She appears today in place of Frank Mason, who is ill.

We welcome all of you and look forward to your testimony.

Before we begin, however, do any other members of the committee have any opening statements they wish to make?

I believe the minority member, Mr. Conte, has an opening statement which, without objection, we will put in the record at this point in time.

[Mr. Conte's statement may be found in the appendix.]

Mr. **Bilbray**. Mr. Chairman, I also have an opening statement, but I will put it in the record at this time rather than take up the time of the committee.

Chairman **LaFalce**. Without objection, it is so ordered.

[Mr. Bilbray's statement may be found in the appendix.]

Chairman **LaFalce**. Any other opening statements? No.

Although it is not my intent to introduce all the members of the committee, I believe another new member of the committee has arrived, Mr. Bill Sarpalius of Texas. We welcome him today.

Mr. **Sarpalius**. Thank you. It is good to be here.

Chairman **LaFalce**. I would ask unanimous consent to put the entire text of all the prepared testimony of the witnesses in the record at this time. Without objection, it is so ordered. Therefore, the witnesses may feel free to either read their remarks or summarize them in approximately 10 minutes, whichever would be shorter. Sometimes the summaries tend to be longer than just reading the prepared testimony. I don't know how it works that way, but it does.

Mr. Satagaj.

TESTIMONY OF JOHN S. SATAGAJ, PRESIDENT, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. **Satagaj**. Thank you, Mr. Chairman. As the first speaker, I will try to set the model for the rest of the year and summarize my remarks in 10 minutes or less.

It is a pleasure to be here. My name is John Satagaj, president of the Small Business Legislative Council. For the benefit of the new members on the committee, the SBLC—the Small Business Legislative Council—is a permanent, independent coalition of over 90 trade and professional associations that share a common commitment to the future of business. Our members represent every industry from manufacturing, to retailing, to transportation, to agriculture, and any activity in between. A list of our members is attached to our testimony.

I want to start my testimony by finishing up business from the 100th Congress. I want to do that by thanking the chairman and the members of this committee for their fine work in the 100th Congress. From mandated benefits to the McCarren-Ferguson exemption for the insurance industry, this committee was very active in representing the interests of small business, and we thank you for your work in the 100th Congress.

On to the new business. Unfortunately, we start this Congress on a less than positive note. We are here today to talk about section 89, and, as the chairman indicated, section 89 is the child of the Tax Reform Act of 1986, a law which, I might note, we viewed with considerable doubt at the time of passage. The emergence of section 89 as a problem for small business only serves to reinforce our belief that, lower rates notwithstanding, the Tax Reform Act of 1986 was, and is, the source of substantial heartburn for many small business owners.

The first question and most logical question to ask is, why are we here today if section 89 was enacted over 2 years ago? There are several answers to this question, but certainly one of them has to be—and this is based on observations during the debate on tax reform—that not more than a handful of individuals on Capitol Hill and the Treasury had any idea what section 89 was all about at the time of passage.

Just yesterday, I received a letter from a group of business owners in Ohio, and they discussed how they had already contacted their Representatives at the beginning of this session about the subject of section 89, and the author of the letter to me states: "Those"—those being small business owners—"who did contact their Representative found them to be uninformed of the complications involved in the administration of section 89. One Representative called back to our office—the small business owner's—and was appalled that he had voted for such a measure."

Our impression today is that this issue is the same as the auto loan fiasco of just a few short years ago. The concept sounds good, but no one had time to consider fully the enforcement. Here we are today, the effective date rolls around, and we are forced to address the problem head on.

We believe our problems with section 89 can be divided into three categories: Our disagreements with the fundamental statutory assumptions, questions of interpretation, and matters that could easily be resolved by better planning and communication by the Government.

In recent years, we have felt an obligation when Congress and the administration undertakes regulatory functions to communicate with the small business community, and we have tried to do so whenever we can. In this case, on the subject of section 89, we have produced a compliance guide, and there is a copy appended to our written testimony. This is what the publication version looks like. I can tell you that I probably spent 200 hours working on this, and there are still some sentences in here that run probably 100 or more words. I can tell you, if you know anything about grammar and editing, that is terrible, yet it is the best I could do, and I readily admit it.

Now what are our fundamental problems? If I could single out one concept that was introduced in section 89 with which we have a very serious problem, it is the concept of an employee. Under the law, an employee is defined as an individual who works 17.5 hours a week or more. This is a dramatic and unprecedented change in the definition of an employee.

I don't need to tell you that those positions, the part-time positions, are an essential point of access for many people into the work force. I can tell you that small business owners faced with the situation are going to start eliminating those positions, and that, to us, is a very grave concern.

With regard to questions of interpretation, in my testimony I have a long laundry list of items of issues on which we have questions, ranging from what do you mean by an indefinite period of time? to what do you mean by a plan? to what are our options? value?

There is an incredible formula—I believe it is on approximately page 8 of my testimony—which actually comes verbatim from the conference report. I defy anybody in this room to come up with the right answer, going through that one example. It is impossible. It is very difficult to follow.

The final set of problems we have with section 89 is the lack of effective communication by Government. This, to us, is an example of how Congress passes a law in a rush. Here it is, boom, the effective date, and the Government hasn't told us a single thing about this law. The chairman mentioned that we still haven't seen the regulations from the Department of the Treasury. In the 1988 Technical Corrections Act, the 100th Congress said, "You must have them out by November 15, 1988." Where are they? They don't exist.

Now there are ways to do a good job of communicating with the Government. In my testimony, I talk about the Immigration Service's I-9 Program. It wasn't a perfect job, but I can tell you, they did a whole lot better in that case, the Immigration Service, than the IRS does in communicating with small businesses. We need to get more information up front before the effective date.

There are several things in this law which, if we simply could communicate better with small business, we would solve some of the problems. I use this example. Many small business owners don't understand the difference between taxable and nontaxable benefits. Right now, they are scrambling around: Does this apply to vacation? It does not, because in theory vacation is a taxable benefit. Now they may not be reporting it as taxable income under another section of the Code, but for the purposes of section 89 it is not a benefit. These are the kinds of things that the Government should be doing up front, communicating.

Realistically, although we make some suggestions regarding changes, simplifications, I am not convinced that any amount of change will make section 89 an easy test with which to comply. We fully endorse the efforts of the chairman to introduce legislation to repeal the law. We believe it is the best way to go.

One thing you learn, dealing with Congress on small business matters, is that seldom do you find that you say to us, "Thou shall not do the following." Instead, it is a situation, and the plant closing law is a good example, where somebody tries to anticipate every possible theoretical way that a business could avoid a law. You track the law to that.

I will tell you what happens then. Nobody can read the law; nobody can understand it. You know what the small business owner says? "I'm going to take my chances. I'm going to wait." We hear that more and more these days from small business owners:

> I'll take my chances. I'm not going to comply with section 89. I'm not going to do anything about the OSHA Hazardous Communication Program. I'm not going to comply with the environmental protection laws. I'll wait until they come down on me.

One solution that we think all of you can undertake here, and the chairman and Congressmen Ireland and Skelton are certainly very familiar with the Regulatory Flexibility Act. We should impose the Regulatory Flexibility Act upon Congress. Back several years ago, Congress said to the agencies, when we enact a law that affects small business, and you have to undertake the regulations to implement that law, we want you to look at the economic impact on small business.

What we think should be done is this Congress should say:

> Every time a committee, a standing committee of the U.S. Congress, considers legislation with an impact on small business, let's do that analysis up front. Let's have a regulatory flexibility bill for Congress.

I think that would be the solution to the problem.

Mr. Chairman, we are glad you are right on top of this issue. You mentioned that you are holding this hearing even before you are organized. This is one issue that if we don't get on top of it, we are all going to be steamrolled like the auto laws rules.

So we thank you for your attention and we certainly support all of your efforts to repeal the bill.

[Statement of Mr. Wayne J. Smith, chairman, Small Business Legislative Council, submitted by Mr. Satagaj, may be found in the appendix.]

Chairman LaFalce. Thank you very much, Mr. Satagaj.

Our next witness will be from the National Small Business United, Mr. James Lagos, its president.

TESTIMONY OF JAMES LAGOS, PRESIDENT, NATIONAL SMALL BUSINESS UNITED

Mr. Lagos. Thank you very much, Mr. Chairman, and members of the committee. I want to express our deep appreciation at National Small Business United for your holding these hearings and taking the time to hear the problems we are having concerning these.

I am basically the chief volunteer at National Small Business United. I, and all my board, are volunteers. We pay our own expenses to come down here and I am glad to be here today and to pay my expenses to come here because of the nature of the problem that we have with this particular section of the law.

I submitted rather lengthy testimony and, following John's good example, I am not going to read any part of that. But I did want to tell you about some of the very practical problems that our people are having out in the field, and frankly, that I and my brother are having.

My brother and I are lawyers by profession and capitalists by desire, I guess. We are involved in various small businesses. We have an industrial contracting firm. We are engaged in farming and various things related to real estate. We have been in such diverse things as beer and wine wholesaling and nursing homes. My wife is in the retail clothing business.

By the way, in our law firm, we represent a lot of small businesses and, on top of that, we represent a lot of employees against small businesses, so we get it from both ends. I think that we have some good perspective on exactly what the practical effects will be concerning this legislation.

Section 89 basically is an ambush. The small business community does not know it is out there. We are just starting—small business people are just starting to find out that it is out there.

John Satagaj mentioned the work that was done preparing everybody for the new immigration law and the fact they have to carry out their Form I-9, and so forth. I dare say that most small business people aren't even doing that, even though it has been in the press, even though it has been on television, and in all the news magazines and the newspapers, that employers are required to fill out one form concerning immigration law reform.

Section 89 is about 100 times or 200 times greater paperwork burden than what the immigration law reform was. Yet, the small business community really hasn't gotten the word out that it exists and I submit to you that basically it already applies to them and basically the small business community is already violating section 89. I dare say that 99 percent of the small business community in this country hasn't heard of section 89, yet it does apply.

If you look at the tail end of section 89, we have a list of things that we have to do, five different things in terms of a written plan we are supposed to submit. Under the technical corrections bill, on page 313, that was just passed and signed into law by President Reagan a couple months ago, we are now required prior to the time that this year began to at least give oral notice, to give a summary statement for employees of the type of information that section 89 requires. As a lawyer, I would tell my people, if you are going to give something to your employees, you better make darned sure you give it to them in writing, so basically, for all intents and purposes, we are required to do those things listed at the tail end of section 89 already in terms of a written program.

Now, most of us are on a calendar-year basis. Under the Technical Corrections Act, on page 313, we were supposed to inform our employees prior to the beginning of our fiscal year in 1989 of these various things as to their rights under the program. So I feel safe to say that almost all of us are violating the law already and it is basically an ambush. Hopefully the Treasury will come out with some written guidelines and cut us some slack on it. But in representing the small business community, you can't really depend upon that.

What we have is a situation where this is really going to hit us. It is not just an esoteric subject.

John was exactly right and a lot of small business people are simply going to go ahead doing what they are doing and hope they don't get caught. But basically what they are doing is walking in a minefield.

Let's use a quick and dirty example. Let's assume that John Smith works for ABC, Inc., which has health insurance and life insurance programs. John Smith gets sick; he has heart problems. He runs up $100,000 in medical expenses. Basically, he and his employer have never heard of section 89, which is, I think, a very practical example. I am sure that is true of most small businesses.

John Smith, then, gets this $100,000 in medical benefits. I submit to you that because his employer has failed to comply with section 89 that those benefits are then taxable. Assuming a 28 percent rate, that means John Smith has to come up with $28,000 in Federal income taxes, which he obviously can't do.

His employer is equally penalized because if they weren't going to comply with the section, they should have listed on John Smith's W-2 form that he was getting as income the premiums on the insurance policy, the $2,000 or whatever, should have been listed on his W-2 as a premium, as an income to him. It wasn't.

Assuming that ABC, Inc., pays a total of $200,000 in benefits out, they then are required to pay regular corporate income tax on $100,000. Now, it gets worse.

Let's assume that John dies. The way I read this section, it would also apply to life insurance. He gets $100,000 from the life insurance proceeds, let's say, from ABC, Inc. His widow, Mary Smith, then turns around and has to pay $28,000 worth of income tax on the life insurance proceeds. The company gets hit with another penalty. There are other penalties the company can get hit with.

It can be even worse than that. Let's assume—and a lot of us that are in small business, like my brother and I, frankly, have different small businesses. These small businesses can sometimes be said by the Internal Revenue Service to be a controlled group of small businesses and they treat them basically by lumping them all together.

ABC, Inc., may be 100 percent complying with the law, but let's assume that XYZ, Inc., which is a part of the controlled group, is not. Then the people involved at ABC, Inc., still get hit and still get ambushed by the operation of the law.

What we see here is a tremendous minefield the small businesses have to walk in, and basically that is exactly what happened. I will be honest with you. In one of our businesses, we had a health insurance program and my brother and I got together and thought this over at the beginning of the year and we decided we can't take the risk; we don't think we could comply; we are going to terminate it, and I will be honest with you, we terminated our program because of the operation of section 89.

In my practice, I am called upon a lot to advise small businesses as to what they should be doing to stay ahead of the law or in compliance with the law. I, as a lawyer, or a CPA advising small businesses, would have to be frightened of the operation of section 89 enough that frankly—and there are a lot of legal malpractice suits these days where lawyers are suing lawyers—to take the easy way out and recommend to my small business clients that basically they simply do away with their health insurance program, maybe raise the pay of their employees and have the employees themselves go ahead and get their own health insurance in their own family plan.

That, of course, would be undesirable from the employee's standpoint because then he is paying income tax on his money and then taking his after-tax dollars and buying health insurance. They can't buy it as cheaply perhaps as they can by working in a group and it is very, very undesirable.

It is quite ironic that last year, we had proposals in the Congress to mandate that employers provide health insurance for their employees and then we get the situation where this tremendous disincentive comes down from the Government that will cause small businesses to cancel their health insurance programs.

I spoke with any number of small business people that I am familiar with and that I represent. Some I don't represent. I spoke with any number of CPA's before coming here today. This is a genuine feeling among the small business people that are aware of section 89, that we may just very well do away with our health insurance programs.

The danger is there that that is going to happen and we are going to have a substantial mass exodus of small businesses from health insurance programs and that those that stay in are going to be in danger of hitting a mine walking around a minefield and they are going to find out they get hit with heavy penalties. Worse yet, their employees get hit with heavy penalties.

It is a lot safer to tell your employee:

> OK, I'm going to give you an extra $1,500 a year; get your own health insurance because if we keep it in our plan, there is always the danger we are going to goof it up and by goofing it up, there's going to be the danger that if you do have this heavy health insurance hit where you have to pay thousands of dollars of medical bills, you're going to have to pay taxes on all of those. So it would be a lot better for you, as an employee, just to do it on your own even though you're losing $700 of it because of the taxes on the money than it is to go ahead and participate in an employer-sponsored group health insurance program.

There are any number of other provisions of section 89 which are minefields for small business. The Commerce Clearinghouse summary of section 89 and the accompanying materials covered some 65 pages and it is a brand new law. I hate to see what Commerce Clearinghouse is going to look like concerning section 89 in a couple years if it is this thick right now.

One other quick point I wanted to make concerning this. In trying to figure out whether or not you discriminate, and trying to figure out whether or not the law specifically covers you, there is an exemption put in—what I call a pseudo exemption, if 80 percent of your people are actually covered by the plan.

I don't mean actually eligible, but they have to be actually covered and a plan in effect covering them. There is some attempt to make an exemption. They are saying if you have 80 percent coverage, that basically you don't have to comply with the eligibility test and the benefit requirements. But I think that exemption is sort of circular and basically a catch 22. The reason I say that is simple.

In the exemption section, which is on the second page of section 89, and I go to great length in my written testimony concerning this, it says that you are OK if 80 percent of your employees are actually covered and if the plan doesn't discriminate. But the only place in the whole section 89 which defines what discrimination is is the part at the beginning of it that defines discriminatory employee benefit plan and it says, "In order not to be discriminatory, you have to meet both the eligibility requirements and the benefit requirements."

So basically, I submit to you that the definition of what discrimination is then eliminates the exemption. I don't think it is going to operate and I think the way it is written—I really don't think there is an exemption. I think that basically any small business that wants to be safe has to comply with the whole of section 89 or basically they have to do away with their health insurance programs.

I think a lot of people are going to take the easy way out, in fact, the prudent way out, and eliminate their health insurance programs.

That completes my 10 minutes. I don't want to go overtime because a lot of other people have something to speak here. I will stick around afterwards for any questions you have.

Once again, I want to thank each and every one of you from the bottom of my heart on behalf of all of our members for holding these hearings, for getting right down to the nuts and bolts about this very major problem that has been thrust upon the small business community of this country.

Thank you very much. Thank you, especially, Mr. Chairman.

[Mr. Lagos' statement may be found in the appendix.]

Chairman **LaFalce**. Thank you, Mr. Lagos.

Our next witness will be the executive vice president of National Small Business United, Mr. John Galles.

TESTIMONY OF JOHN PAUL GALLES, EXECUTIVE VICE PRESIDENT, NATIONAL SMALL BUSINESS UNITED

Mr. **Galles**. Thank you, Mr. LaFalce, and thank you members of the House Small Business Committee. I will dispense with reading my remarks and get to what I see to be the heart of this matter, and that is, the frustration that Congress is experiencing attempting to deal with mandated health.

You are all concerned, and indeed small business is concerned, about the 37 million Americans who are uninsured or underinsured. The best thing you could do to help them get insurance is start to deal with our Federal budget deficit in a clear and direct manner, so that the Government can get back to providing the kinds of minimum coverage through Medicare and Medicaid that some of our poor citizens need in this country instead of ducking the issue and expecting small businesses to pay that bill.

There are economies here and we respect what the Ways and Means Committee staff members were attempting to do, what Senate Finance Committee staff members were trying to do, but what they did was exactly what Mr. Lagos has said: They have ambushed you and they have ambushed the small business community, and my members are angry as can be about this.

It is unfortunate that the net result of this section 89 will be to reduce coverage for individuals in this country or to place more of that burden on individuals, less of that burden being taken by small businesses. I think the assumption that was made was that all benefits cost the same to all businesses and therefore benefits can be taxed at an equal level or applied on an equal level, and small businesses know better than that. Small businesses face a disproportionately high cost of benefits because of economies of scale. They do not have many employees, so when they buy things they have to pay more than larger companies do.

One of our member organizations in Cleveland has a substantial health program where they cover nearly 5,600 small businesses in the Cleveland area. Yet, when they compare their cost for their individual members to those costs borne by large companies, they still find that their health coverage is 40 percent higher than what it costs the large business. It is important for Congress and for staff members to understand that impact on small business. If they try to tax benefits, if they try to mandate benefits, they are going to destroy one of the most profitable, one of the most exciting sectors of our economy which is keeping the United States competitive in a way that we need to be proud of and supportive of.

I did my best to gather some examples for you because I think it is important for you to know how people are reacting. One of the first examples I got was from a company in Wisconsin that makes seats for airlines. They employ 146 people. The owner of the firm has previously contributed 100 percent of the health benefits there, but instead of paying to figure out how to comply with the coverage, he dropped it completely. He said no coverage assures no discrimination. Is that the kind of response that even those well meaning staff people expected when they injected this into the Tax Reform Act?

An insurance agency in California with 28 employees had plans to extend their coverage to improve their benefits to keep more of their employees at that small business, but they have decided to cancel all of that in the process.

The main reason is cost, and the cost is the one that small business owners know very well. They have to compete for the available employees in the work force. As you know, with our longest expansion in history in peacetime, we have now one of the lowest employment rates in our history. As a result, small business owners have to work very hard to keep the employees that they have hired and that they have trained, and the way to do that is to supply them with benefits in addition to their salaries. Those benefits help them keep that talent and help them avoid losing those employees who they have trained to other businesses, to larger businesses who can afford more benefits at a lower cost.

The cost of compliance here too is another question that needs to be addressed. Because this bill—which has been quoted to supply our Federal Treasury with nearly $200 million—in analyzing the impact of compliance you have got to see that it will end up costing our Federal Treasury more than the expected $200 million.

We talked with a number of individuals who do consulting, from lawyers to CPA's, at a recent CPA seminar in California. The CPA's laughed, thought that this was a practical joke or a way to improve business for CPA's. One individual person is charging his clients $5,000 per test. Five thousand is pretty steep for a lot of the small businesses I know. A consultant for a Boston firm has quoted a figure as high as $50,000 because he is concerned about the liability in the discussion. But an attorney from Kalamazoo, MI, claims that no one can possibly guarantee that a business will comply, because the rules are so unclear.

In case after case we are finding that people are dropping coverage rather than extending coverage, and I think that is the message that has to come through to people with this. This is not an incentive. It is not helping small businesses buy health insurance. It is not reducing the cost of insurance. It is not increasing competition for the coverages that small businesses buy. This was a short cut somebody tried to take along the way that ended up being a roadblock for small businesses rather than an aid.

Another person who did some tests found that of the 30 plans that he had tested, only 12 percent had passed. A small business owner in Texas reads the penalties and says that they are so astronomical that he, too, is fearful of the law and in fact is going to drop his coverage.

I think you need to understand that from a competitive standpoint there are times when small businesses simply cannot afford to treat all employees equally from a benefit perspective. That is the same reason why all employees are not paid the same salaries. There are costs imposed with hiring people, with training people, with attempting to compete in the marketplace, now in our international marketplace, and small businesses are trying to fill niches. They do that by hiring people on a part-time basis. They do that by hiring people in flexible schedules. They do that in reducing their costs, and expecting them to pick up a bill that they simply can't afford will either put them under or reduce the size of their operation substantially.

The alternative, Mr. Chairman, that you have asked for I think requires us to go back to the Ways and Means Committee, which ought to pay attention to this issue, which has been ducking us to this point. We hope they won't duck us much longer because small businesses across this country deserve their respect and their attention with regard to section 89. I would hope that each and every one of you would ask Mr. Rostenkowski for some time, would ask the members of that committee to pay attention to this issue, to reopen discussion of section 89 and explore the possibilities with small business in a cooperative manner rather than ignoring the issue and refusing to talk to us. Thank you.

Chairman LaFalce. Thank you very much, Mr. Galles.

[Mr. Galles' statement may be found in the appendix.]

Chairman LaFalce. Our next witness will be Mr. Donald Corbett, owner of Servicemaster Professional Cleaning of Fairlawn and representing today the National Federation of Independent Business.

Mr. Corbett.

TESTIMONY OF DONALD CORBETT, OWNER, SERVICEMASTER PROFESSIONAL CLEANING OF FAIRLAWN, REPRESENTING NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. **Corbett**. Thank you, Mr. Chairman. I am here as a member of the National Federation of Independent Business. I am going to read my own statement, but I would like to submit NFIB's statement for the official record.

I am the owner of a small cleaning company which provides janitorial services and project cleaning to commercial buildings, plus residential cleaning of carpets, furniture, walls, and so forth. We also work with the insurance industry cleaning up after fires and floods. Our company employs 36 people including myself.

We presently provide hospitalization benefits for all employees who work 30 hours per week or more on a regular basis. We provide full payment for single employees and pay a like amount for married employees with them paying the difference.

Perhaps it is not a great program, but it costs our company approximately $1,900 per month on sales of approximately $36,000 per month. It is a very large sum.

Of the 36 employees, we have 12 who are working 30 hours a week or more; 15 are working between 17½ and 30 hours, averaging about 22½ hours per week; and there are 9 employees that are working less than 17½ hours per week.

Section 89 of the Tax Reform Act of 1986 says I have a discriminatory plan, at least I think it does. It has been very difficult for me to determine exactly what the regulations say. I guess I feel it is not right for a law to be so complicated that the people it affects can't understand it.

I have received charts and pages and pages of writing that are supposedly explaining this regulation to me, and still it is unclear. The accountants I have contacted do not have a clear understanding of section 89. One company that quoted on health insurance this past year says one law firm is charging $2,000 to write up a plan so small businesses can be in compliance.

I am also concerned when the IRS brings out their clarification they will be as clear as their clarification of last year's W-2 form was.

As a small businessman, I want as many of my people to have hospitalization as possible. Even though our business, a cleaning company, is low in status, it is still an important job and I need to have stability to provide our clients with the quality that we want to give.

I have done more than a lot of cleaning companies in our area as far as providing hospitalization is concerned, yet my plan is discriminatory. Why should employees working 17½ hours per week be entitled to the same benefits as employees working 30 hours per week?

Another thing, to be nondiscriminatory a plan must be permanent. I am not in a position to say a plan is permanent. My hospitalization premium was quoted with a 90 percent increase last year. I changed to another company and the effective increase was brought down to 30 percent. This year one of our crew chiefs had a heart attack. My rates increased 70 percent, but because of the heart attack no other company will take our insurance unless he is dropped from the program. I can't in fairness do that to my crew chief, so I have elected to stay with the 70 percent increase.

If the rates continue to raise at these percentages, I can't promise I will continue the program. I cannot raise my prices to cover these costs and remain competitive.

If the Government wants business to handle health care, it is going to have to do something to stabilize the costs. Otherwise, there are going to be an awful lot of unstable jobs as businesses give up and throw in the towel.

I have a deep concern for my employees and want to do everything I can for them. I do not feel it is proper, however, to call a plan discriminatory when it does not cover employees who work under 30 hours.

Congress, on the one hand, says that it is concerned about the competitiveness of the U.S. business community compared with the rest of the world, and the recent trade figures indicate that this is a legitimate concern. Then Congress puts together a regulation that serves absolutely no useful purpose other than adding legal and accounting expenses.

I presently spend a great deal of time and money to maintain records for the Government and to collect their taxes. This regulation appears to add monumental amounts of recordkeeping and legal work that adds absolutely nothing to productivity. If Congress wants to raise the productivity of business, it must eliminate its adversarial role.

Congress should be developing incentives for employers to offer benefits to employees, and these types of regulations, along with the volatility of benefit costs, negatively affect my thinking on the types of benefits that I can offer to employees.

If Congress insists that some type of discrimination regulation is necessary regarding benefits, then it should be simplified and a more reasonable criteria established than 17½ hours per week. My teenage daughter has babysat over 17½ hours just during a single weekend.

This regulation will have no beneficial impact on employees. Large firms [illegible] firms with highly skilled employees probably already have good plans for their employees, but they will have to spend good money to prove it and comply with this regulation. Firms that employ many unskilled employees will be changing their employees every 6 months as the law now stands. Some of the businesses in my line of work do that now, just to avoid the pressures of employees asking for raises and benefits. Now there is a regulation that encourages more of that kind of thing.

Is the regulation really going to benefit employees or is it going to discourage employers from offering benefits? In the long run, I feel it will have a negative impact on employees and businesses.

It is my opinion that this regulation should be repealed in total as detrimental to business in general and employees in the long run. Thank you, Mr. Chairman.

[Mr. Corbett's statement and the statement of the National Federation of Independent Business may be found in the appendix.]

Chairman **LaFalce**. Thank you very much, Mr. Corbett.

Our next and last witness will be the representative from the U.S. Chamber of Commerce, Ms. Diane Large.

TESTIMONY OF DIANE LARGE, VICE PRESIDENT FOR PERSONNEL, U.S. CHAMBER OF COMMERCE

Ms. **Large**. Good morning, Mr. Chairman, and members of the committee. I am Diane Large. I am vice president for personnel and facilities management at the U.S. Chamber of Commerce.

The U.S. Chamber has over 180,000 members with 85 percent of our members being small businesses. We very much appreciate the opportunity offered today to present some comments on behalf of our members and small business in particular.

I would like to summarize my written statement, and I plan to focus my comments on the mechanics involved at the U.S. Chamber, as an employer, to comply with section 89; and I think it fairly represents what small business people will also face in complying with section 89.

At the U.S. Chamber in Washington, DC, we have 400 employees as well as a group of retirees. The plans we must test under section 89 include health care, life insurance, supplemental insurance, accidental death and dismemberment, and a new benefit we just introduced, our flexible spending accounts benefit covering both health and dependent care. I would like to just isolate our health plans to illustrate what is involved in complying with section 89.

We offer one indemnity plan and two health maintenance organizations to our Washington staff. To test these three health plans under section 89, we have to break them down into components. We have to separate active employee benefits from retiree benefits, and then break them down further into single coverage, single plus spouse, and family coverage. Each of those options then becomes a separate plan and we end up with 14 plans from our basic 3 choices, each required to be tested separately.

Compliance requirements are burdensome. We need to identify who to include and who is exempt based on hours worked or date of hire or other outside coverage. We need to identify the highly compensated.

Data collection requirements are extensive. Those requirements, as I understand them, are listed in an addendum to the written remarks. There are up to 42 separate bits of information required on each employee, and even though we are computerized we don't have all that data. Smaller businesses are much less likely to have that kind of information available.

Requesting this personal information has also caused some employee relations concerns. For example, we had to request information about health coverage under a spouse's plan and some employees were suspicious that we were trying to eliminate their Chamber-provided benefit.

The first testing segment is a five-part test qualifications standard and it is primarily dealing with employee communications. We are awaiting regulations to see whether our plan communications meet section 89 requirements. If not, all of our booklets will have to be revised and reissued. It seems likely that the small business person may not have formal enough benefit descriptions to meet section 89 requirements.

Failing these qualifications, as was stated previously, can result in some staggering financial burdens, particularly on the employees. The example of large benefits being paid and being taxable to the employee was already mentioned, and that is a real concern.

Assuming we pass the test qualifications on our plans, we proceed with the nondiscrimination testing on each plan. With our 14 separate health plans, as defined under section 89, we end up conducting 56 separate tests. If we fail, excess benefits to the highly compensated are taxable.

This covers our Washington, DC, employment only, and our situation becomes more complex when we look at our national employee population. We have small business members who also extend beyond their one State location and are faced with the complexity of section 89 as it relates to integrating their outlying offices.

Small business goes through the same problems I am going through and many or most of them do not have the internal personnel experts, and it requires heavy outside consultant fees. The chamber has talked to outside consultants and one bid I received, which was the lowest bid, for testing of chamber plans was $27,000 minimum. We still collect all the data. The fee is for testing only. If we fail, there would certainly be additional consulting fees to help us come into compliance.

One of my personal small business contacts includes my own insurance agent who has three employees. His accountant will test his benefits for $1,000 and, again, this does not include any consulting fees that would be required to bring him into compliance. Another local small business that performs section 89 testing has a minimum fee of $3,500.

Section 89 is steering employers away from choice. Flexible benefits and multiple health plans complicate testing and probably assure failure under section 89. For example, on January 1 the chamber eliminated two HMO's, and we were partly motivated by section 89. By eliminating these two HMO's, it reduced our health plan testing from 22 separate plans to the current 14. However, it also affected 144 of our employees, who had to choose a different health plan option.

Mr. Chairman, we recommend section 89 be repealed. It will hurt employees, and, I believe, will worsen the health care crisis in this country, and will affect other benefits as well such as life insurance. We predict benefits will be simplified, reduced, or eliminated, especially by small business, due to the burden of section 89. Thank you.

Chairman LaFalce. Thank you very much.

[Ms. Large's statement may be found in the appendix.]

Chairman LaFalce. All of you represent small business organizations, and you now know that this section became law as part, a small part, of the Tax Reform Act of 1986. Different of your organizations supported that bill, different of your organizations opposed the bill in the aggregate. Everyone, even those who were its most ardent champions, had problems with this specific provision or that specific provision.

I do not recall, however, ever hearing of a discussion much less a full-fledged hearing on the subject of section 89. Could any of you refresh my recollection, either corroborate or refute that? Mr. Satagaj.

Mr. SATAGAJ. I can't recall hearing it either, Mr. Chairman.

Chairman LAFALCE. Mr. Lagos?

Mr. LAGOS. I agree with you there was quite a bit of discussion of the Tax Reform Act of 1986. Our organization actually came out against it and urged a no vote. But section 89 was basically a sleeper in there. I think one of the reasons it was a real sleeper is, if you read it your eyes sort of glaze over. I mean, just the extreme technical nature of it. I enjoy these types of bills. I mean I do this for recreation. I would like to think of myself as at least semi-intelligent and semi-educated. You read it over and you are just wondering what it all means, quite frankly.

Chairman LAFALCE. Mr. Galles?

Mr. GALLES. I don't recall any discussion of it at the time. I do recall that there were extensive discussions by Ways and Means about how they were going to simplify the tax law and make it more fair, and I remember, in the Senate, how they reached those conclusions in the 11th hour and all of a sudden everybody bought into a package.

Chairman LAFALCE. I want to focus in on section 89 in particular. Mr. Corbett, I know NFIB strongly supported the Tax Reform Act of 1986, although clearly not each and every one of its provisions. Do you recall ever hearing of any discussion on section 89?

Mr. CORBETT. There was no discussion on section 89, and, as a businessman, I had never heard of it until approximately October or November, and my accountants weren't even aware of it.

Chairman LAFALCE. Ms. Large?

Ms. LARGE. I would agree with their comments, Mr. Chairman.

Chairman LAFALCE. All right, the reason I went through that little exercise is because there are a number of approaches that could be taken, and one approach that could be taken is to repeal section 89, and that is the approach that I have opted for. Another approach is to delay its effective date for an additional year, let's say January 1990 as opposed to January 1989, to try to come up with some tinkering here and there to make it more understandable and less onerous, less of a burden. Another approach is to do nothing, and simply wait for the Treasury regulations to come out within a month or so, I am told, and say you have to live with it.

But because it was included in the 1986 Tax Reform Act without the benefit of hearings or outside input, I think the most appropriate approach is to simply repeal it and then put the onus, not on those who object to it, but put the onus on coming up with some legislation on those who would propose it in the first place—an onus that they never really did meet except through sneaky legislative tactics. That is often what happens with tax legislation, and most often the Members of Congress, at least in the House of Representatives, have absolutely no recourse because we have to vote on the bill yes or no in toto. Literally thousands, ten thousand separate provisions, perhaps, and we have to vote yes or no.

If that is going to be the methodology, then it seems to me when there is this much of an outcry and this much prima facie evidence regarding the arbitrariness of it the appropriate approach that we should repeal it and then let the Ways and Means Committee start from scratch in trying to make their case regarding its need and regarding its probable beneficial effect, rather than its hope for a beneficial effect. At least that is the stance that I take and that I would hope other members of this committee and Congress would take.

A number of members have left. To my knowledge, every member who has had to leave today's hearing has come up to me and said, "Please put me on this bill as a cosponsor," and I hope before every other member leaves that they will be doing exactly the same thing.

I will now turn to my Republican colleague, Mr. Ireland.

Mr. **Ireland**. You have called attention to something else that should be brought before us and some of our other colleagues in Congress.

Mr. Satagaj, with tongue in cheek—maybe it shouldn't have been tongue in cheek—said maybe we ought to have a regulatory flexibility law for the Members of Congress when we act, and indeed that might produce some pretty good results.

Mr. Chairman, we have got to stop such sleepers in the future, and I would suggest to you, isn't it interesting that the three principal sleepers of this type have all come from the IRS? There was the auto log operation, there was the W-2 fiasco, and now we have section 89 on our hands. Isn't it interesting that the one principal agency that says that it is not covered by the Regulatory Flexibility Act is the IRS and yet is the source of problems of this kind?

Since 1980, in all other agencies we have had a limited amount of fiascos where people didn't take into consideration the impact on small business by their regulation except in the case of IRS.

I think we should do two things. I think we should knock out section 89 and let those that want to solve the problem solve it instead of those that would be hurt by it, and, at the same time, I think we should work very hard to include the IRS in the Regulatory Flexibility Act.

Mr. Chairman, I commend you on your having this hearing.

Chairman **LaFalce**. Thank you very much, Mr. Ireland.

Before we go to our next witness, I just want to clarify that today I will be introducing two bills. One is to repeal section 89. But we do have a serious health care problem within the United States. There are 35 to 40 million Americans without health insurance, and there are a number of different approaches that can be taken to deal with that problem.

I do not think section 89 is a good approach, I think it is a bad approach, I think it exacerbates the problem. But, clearly, one approach that should be taken is to create parity among firms who are presently discriminated against under the Tax Code exclusively on the basis of their legal identity. That is, if a firm is a corporation, it is entitled to a 100 percent deduction for the costs of health benefits that it would provide. If a firm, however, is not a corporation, a partnership, sole proprietorship, et cetera, it is not entitled to a 100 percent deduction; I believe it is—what?—25 percent.

Now there is no valid justification on the face of this earth for such discriminatory treatment exclusively because of the legal identity of the business or firm, and so, while you may show interest in cosponsoring the repeal of section 89, I would also hope you would express interest in cosponsorship of the bill to extend full tax deductibility to all firms providing such benefits regardless of their legal nature.

With that, Mr. Sisisky.

Mr. SISISKY. Thank you, Mr. Chairman. The longer I stay in Congress the more delighted I am that I voted against the 1986 act.

Chairman LAFALCE. I am sure your constituents will hear that often.

Mr. SISISKY. I voted against the 1986 act for a variety of reasons. Section 89 was not one of them, although I come from a small business background. I headed up a trade association here in Washington, a very large one, before I came to Congress. That trade association never picked up on the implications of section 89. I'm really concerned that the trade association failed to see this coming. I am going to find out why my former trade association didn't pick up on this when they have people that just read bills and look for potential problems like section 89.

This situation is similar to the catastrophic health insurance legislation. At every town meeting I go to, everybody brings the health insurance issue up. When the catastrophic health insurance plan was being considered by Congress, however, I didn't hear from too many groups. Unfortunately the same thing has happened again.

Having said that, I voted against this legislation, though there are some reasonable arguments for discrimination in employee health plans. I think there has, to some degree, been discrimination. But don't most of our pension plans come under antidiscrimination laws? Have we had problems with that? You are an attorney, am I correct to think that pension plans have to pass a discrimination test? I don't remember having too much trouble with that or hearing complaints, Mr. Lagos, have you had any problems?

Mr. LAGOS. To be honest with you, one of the businesses we are involved in had a pension plan. The problem was, that got so complicated, we also got rid of our pension plan.

Basically, there are things that can be done, I think. The lesson, the administrative compliance nightmare that we had right here. The problem I have got right now with section 89 is that it is so complicated that there is no way a small business can comply. I mean, as my dad used to say, the expression he used to have, "You are guilty before you turn the key in the morning," and I think that is certainly the case with small business and section 89.

Mr. SISISKY. Of course, without the Internal Revenue rules, we don't really know whether we can comply, do we?

Mr. LAGOS. Right.

Mr. SISISKY. Of course, the IRS has a tendency to change the little things.

Mr. LAGOS. Gradually, I am sure that with section 89 that could be done also, but I still would go back to the approach that the chairman makes, and that is that section 89 has to be repealed. I don't think that the way it is set up right now or anything close to it will work. I understand what you are saying about, there is genuine discrimination with small businesses and their health insurance programs. There is absolutely no doubt whatsoever about that. But the way you are doing it here with a complex mathematical formula that, I have to be perfectly honest with you, I don't know how to apply even though I have read it several times now, it simply is not going to work.

Mr. **Sisisky**. I don't disagree with you, but I would like you to go through your example using this ABC company again because I didn't quite understand everything you said. Could you run through it quickly?

Mr. **Lagos**. If I could summarize just in a few sentences, what it says is that, basically, if you are not in compliance with the plan you are supposed to be reporting the cost of the benefits that your employees get on their W-2 forms. If you are paying $2,000 to $3,000 for health insurance for your employees and you are not in compliance with the plan——

Mr. **Sisisky**. All right; Let's stop right there.

Mr. **Lagos**. OK.

Mr. **Sisisky**. Who determines that you are not complying? Does the the Internal Revenue advise you of that before the fact? After the fact?

Mr. **Lagos**. No; definitely after the fact. Unless you, yourself, know you are complying with this law, you are required for every nickel you spend in benefits for your employees for health insurance, for life insurance—and there is some other stuff in this section too like employee discounts, employer-operated eating facilities, anything in a cafeteria plan—the value of all of those things that you are doing for your employees is supposed to go on their W-2 forms.

If you don't put it on their W-2 forms and they don't pay taxes on that as regular income, then all of these horrible things, the examples that I gave, come to pass because what gets taxed is—when the IRS catches you, you don't get taxed, the employee just doesn't get taxes on, let's say, the $3,000 or $4,000 of income that he should have reported, he gets taxed on the benefits.

Mr. **Sisisky**. On the benefits?

Mr. **Lagos**. Right; so if you have got a vast amount of benefits that you get—and I can see the IRS now requiring hospitals to start reporting who has had large benefit payments made on their behalf. It is a real ambush situation.

Mr. **Sisisky**. Mr. Chairman, I think this point is very important, and that is why I asked him to repeat it. The tax isn't on the amount of premiums.

Chairman **LaFalce**. No; it is benefits.

Mr. **Sisisky**. It is on the benefits, which is a horrifying situation. I guess my time is up. Thank you, Mr. Lagos.

Mr. **Lagos**. Thank you very much, Congressman.

Chairman **LaFalce**. Thank you. I can really see that happening. The hospitals would report all the benefits to the IRS, and then half the people would be penalized on it, even after they are dead.

Our next member, Mrs. Meyers.

Mrs. Meyers, did you have any questions you wished to ask?

Mrs. **Meyers**. Yes, I do, Mr. Chairman.

This issue has been very frustrating, I think, for all of us, because I think most of us agree that we want to provide health insurance for the working poor and middle-income people without mandating it, and that is the thing that is waiting in the wings if we don't find a method of doing this.

I think we all agree that it is not right to provide some kind of a Cadillac plan for people that earn $50,000 and nothing for the person who is just starting out, who is earning $20,000 and has a family and probably needs a plan a great deal more than that higher compensated employee.

But I think most of us are also very concerned because we have heard so much from our districts about the complexity of this plan. So I would like to ask some questions about that, Mr. Chairman, about maybe how we can simplify this a little.

I would also agree with the chairman that I think we have to stop the sleepers from getting through in the bills. Businessmen feel betrayed when they don't have a hearing first, they are not allowed to state their case or how maybe they could improve the legislation. However, perhaps we are being a little too hard on ourselves, because, as you will recall with the Tax Act, when it went to the Senate and then it came back to us, everything was changed. I mean it was a totally, entirely different bill, and many of the deductions were simply wiped away in the Senate bill. I am not saying that I disagree with that Senate bill, I am saying that at that time, although we had worked on the bill for 2 years in both the Senate and the House, in just kind of one stroke that entire bill was changed.

Let me ask a question. Somebody said that the definition—I believe Mr. Satagaj said it—you said that the definition of an employee of 17.5 hours was inappropriate, and yet I think we have all heard of firms that would hire individuals for 38 hours in order to avoid providing benefit packages that they would have to provide if they were hired for 40.

What is a good number of hours so that we can make sure that people aren't just bending the law by hiring just under the maximum number of hours and yet is not too low? What is a good compromise there?

Mr. Satagaj. Obviously, any number I pick is going to be a little bit of picking it out of the air, but somewhere on the order of 25 to 30 hours really begins to represent a full-time employee. In fact, under ERISA regulations it is a little bit lower than that.

I guess the key here is that there is consistency, but it is a level that reflects the difference.

Chairman LaFalce. What is it under ERISA?

Mr. Satagaj. Mr. Chairman, I can't give you the exact answer. I believe it might be 22.5. This would be a good question to ask Paula Calimafde tomorrow. I believe she will appear on the panel in your next set of hearings. She is a pension expert. The questions that Mr. Sisisky had about the pension area I would direct to her. She would know the answer to this question.

Mrs. Meyers. Thank you. Mr. Lagos, you said something and I couldn't quite follow you. I have talked to a lot of my businessmen at home about this, and I have tried to understand, and I really am sympathetic with all of the complexities. But you said that the definition eliminated the exemption of 80 percent, and I did not understand that.

Mr. **Lagos**. Basically, Ma'am, section 89(d) and (e) set forth the eligibility requirements and the benefit requirements. You skip down to section 89(f), which is the exemption. That says, basically, if you have got 80 percent coverage, that 80 percent of the employees who are not highly compensated employees, if they are covered—in fact covered, not just eligible but covered—then there is an exemption and you don't have to go through all the rest of these tests.

But it adds at the bottom of that that the preceding sentence shall not apply if the plan does not meet the requirements of subsection (d)(1)(c). You go up to the top of that, and subsection (d)(1)(c) says that for purposes of this section a discriminatory employee benefit plan means any plan unless it meets the eligibility requirements and the benefit requirements.

So it is sort of a circular thing. I think it is a catch 22, that we have got this exemption, but in order for the exemption to apply you have to be able to say you don't discriminate. The only place in section 89 that actually defines what discrimination is in this context we are talking about here today is this section 89(1)(c), which defines it in terms of anything that doesn't comply with the eligibility requirements and the benefit requirements.

So I really think it is a circular type of exemption, and I think the argument can be made—I don't know if the IRS is going to make this argument, and I don't think they know right now if they are going to make the argument or not—but I think a very strong argument could be made that, basically, unless you meet all those tests you don't have an exemption.

Mr. **Satagaj**. If I can just add one thing, to give you an example of how this gets so complicated. You mentioned the safe harbor, the 80 percent. Yet the truth of the matter is that one safe harbor tells you, when you compare your plans for the purpose of the 80 percent, that you have to have a value range of 80 percent or more. In other words, if you have 10 plans and they are all a little different, they all have to fit within a range of 80 percent.

But the law goes further than that and says, "If the benefits fall within a higher percentage range, 90 percent, then you can lower the percent in the harbor." Now, by the time you are done reading all that, you no longer know from where you are starting. So even though it is safe harbor, as Jim knows, to calculate that safe harbor, it is not only the circle he is talking about, but you have these tangents where you have to value the benefits and they have to come within a range. It gets incredibly complicated even in the safe harbor.

Mrs. **Meyers**. Mr. Chairman, I would really like to hear from these gentlemen and from Ms. Large about how they would go about providing—making sure that health plans are provided for the whole range of employees and avoid some of these complexities.

I don't support repeal, Mr. Chairman, possibly a delay until we get some rules. I don't know what is holding up the rules. I don't know whether they can't develop the rules or whether it is because of the transition between two administrations——

Chairman **LaFalce**. One of the difficulties is the rules must be in conformity with the law and that is one of the difficulties.

Mrs. **Meyers**. The law is flawed. I would agree with you. I do think it is flawed. I do think it is enormously difficult. We shouldn't do this to businessmen. But I agree with the basic principle. I agree with the goal. I guess that is why I am asking you if—you are businessmen, you are all intelligent and you all have worked with this so that you understand the complexities. I would certainly like to hear from you about the ways that we can improve and change this law.

My chief fear is if we don't do this, we are going to move gradually into some kind of mandated benefits plans and I think business will find that more difficult than section 89.

Mr. **Satagaj**. Mr. Chairman, I know we don't have much time to answer this question, but there was an important point that Mr. Corbett made that relates to mandated health issue and insurance coverage.

As he talked about his costs, health care costs going up, and at one point, he referenced 70 percent, 30 percent—when I go into a room of business owners and I say the subject is health care, the only thing they want to talk about is health care costs.

I haven't met a business owner in the last 2 years who has given me a figure of less than 30 percent increase in their health care costs over the last year. So while it is not a direct answer to your question of solutions to this, if we want employers to provide health insurance, we do have to deal with the question of health care costs. We are not doing this.

Mrs. **Meyers**. Mr. Chairman, if I can take just another minute, I would agree absolutely with you. This is a problem that Congress has tried to address since long before I got here; and when I was in the Kansas legislature, we were dealing with prospective payment systems that would cover not only Medicare but that would cover Medicaid at the State level. Blue Cross/Blue Shield was trying to develop prospective payment plans that would deal with private insurance to try to stabilize and moderate the cost of health care.

I don't think that this is a problem that is just affecting Government. I think it is affecting all private plans and everybody. We have to be able to deal with it. I think a big share of it is that we are doing a number of procedures because of medical malpractice and perhaps that is one issue this committee could address that would help with health care costs.

Mr. **Galles**. Mrs. Meyers, if I could just react in kind of a summary response, a number of organizations have recommended ways to improve the percentage of coverage by small businesses in the marketplace. They start with the recommendation Chairman LaFalce has made about the deductibility for unincorporated entities.

They proceed through a number of other options, including some changes in ERISA laws that would allow multiple employer trusts that would encourage businesses like Mr. Corbett's and Mr. Lagos' to join together to purchase insurance at a level that allows them to cover more employees, some exemption from State-mandated benefits which can be extended to large businesses who self insure, but cannot be extended to small businesses.

Beyond that, I think we have to look at a lot of the creativity that is going on in our States right now. It is not just Massachusetts who has responded with a heavy-handed employer-imposed cost. There are some very creative plans in Oregon and in Washington right now that approach the problem much differently, more of a carrot instead of the stick, and I think we are going to learn a lot from those and hopefully find better ways of solving the problem. Once again, it may be that States are acting because we are unable to act on a Federal level.

Mrs. **Meyers**. Thank you, Mr. Chairman.

Chairman **LaFalce**. Thank you.

Mr. Lancaster.

Mr. **Lancaster**. I don't have any questions. I am like Mr. Sisisky; I didn't vote for tax reform. The reason I didn't, I wasn't here, so I can completely be absolved of all responsibility, which I frequently point out to my constituents when they write to me about some of the other disasters that were visited upon them in the 1986 Tax Reform Act. I am happy that I came in 1987. It looks like I will spend my congressional career trying to straighten out the mess that was made. I have no questions.

Chairman **LaFalce**. Thank you very much.

Mr. Hancock. No questions.

Mr. Hiler.

Mr. **Hiler**. Thank you, Mr. Chairman. I voted for the Tax Reform Act of 1986 and I think, by and large, it is a pretty decent act, but I think this does point out the difficulties that any Congress is going to have when it tries to pass substantial legislation that makes fundamental changes in the way we are going to approach something.

This was the most fundamental rewrite in the tax laws in over 30 years, and I don't think anyone could suggest that we could have that type of fundamental change in the tax laws, in the concept of our tax laws, without having problems erupt. This clearly is one of the problems that has erupted that has to be dealt with—and needs to be dealt with soon.

I frankly am a little bit less charitable than some are toward the motivations of why this section might have been put in to begin with. I don't remember that a lot of the discussion in the Tax Reform Act was how we can go about ensuring that adequate health insurance is provided to all people.

There was a major change in where taxes were going to be collected. Some $100 to $125 billion of tax collection over a 5-year period was being shifted from being collected on the personal side of the tax equation to being collected on the corporate side of the tax equation.

In order to fund the substantial decrease in tax rates for individuals, as well as to pay for the significant increase in the amount of exemptions of individuals and for families, there had to be some type of revenue generated on the corporate side of the equation.

If you will remember, we eliminated the investment tax credit; we made major changes in the way the tax laws would affect investment in housing and real estate and we also had a whole range of little paragraphs in the bill, like section 89, in order to try to generate revenues.

I think the reason section 89 was put in was to generate revenue and it was to generate revenue in some way that would be a little bit of a back door way toward taxing benefits. If you go back to 1983 or 1984, in one of the tax bills up around that time period, one of the major suggestions that was out on the table was taxing health insurance and taxing benefits over a certain amount. I think it was over $250 a month or $200 a month of benefits provided would be taxed.

I think section 89 is just the logical extension of that type of effort. I think it points out the fallacies of taxing benefits and why we ought not get into that business.

The statement was made by Mr. Sisisky about what had happened in the area of pension plans with some of the massive amount of regulation that we put on pension plans, and I think maybe the five of you could confirm this. But my recollection is that there has been a substantial decrease in the amount of small business pension plans. They have moved to profit sharing. They have moved to other forms of compensation that get them out of having to comply with the pension plan area.

Frankly, we have continued to have major changes in pension plan tax law over the last few tax bills and that is driving even more small businesses out of providing pension plans.

Is my understanding correct or——

Mr. **Galles**. That is an accurate reflection. We have been doing small business surveys with our members for a number of years and the conclusion is the same. People are backing away from providing pension programs because, again, of the complexity.

It is not a good example to use as a way to change section 89. We don't want section 89 to become——

Mr. **Hiler**. I think what it points out is that sometimes with—let's just say I were to be charitable and say that the reason for section 89 was genuinely to try to increase the spread of health insurance, it is one of these cases where the cure is worse than the disease because the cure is going to drive more people away from providing health insurance plans.

Frankly, with some of the complexity with section 89 and the pension plans and others, I think more and more small business is going to go and say:

> Look, we're going to pay you in your paycheck, and that's the way it is going to be. You go out and buy your own health insurance. You go out and buy your own day care. You go out and provide for your own dental benefits. We're just not going to get into that business because the pitfalls that we find ourselves in are just too extreme.

I was just—frankly, I thought I had read about all the letters I could possibly read on section 89 and hear the horror stories, but listening, I think, Mr. Lagos, to your analysis of—I think it was yours—that what will happen if a small business does not conform unknowingly and what then happens to the poor devil who is working for the small business that didn't conform if they happened to have had a major health benefit that year.

It is frightening and if we think we are having calls and letters on catastrophic health insurance, wait until we start having some calls from people who get hit with a big tax bill from the IRS because they utilized the health benefits under their employer-paid-for health plan.

The last point I would make, and I will yield back—I know I have gone on a little bit longer—the 17.5-hour per week test as to when discrimination kicks in or not and the fact that a benefit would have to be planned, if you look at some of the plans that have been introduced in the Congress, both in the House and the Senate, as to the determination of mandatory health insurance and when a small business would have to provide it, it is that same 17.5-hour figure.

It seems to me that what we have done in section 89 is once again a back door way to try to mandate without coming out and mandating and I think it is going to backfire tremendously. I believe I am a cosponsor of the bill already. If I am not, Mr. Chairman, please include my name, in both of your bills, incidentally.

Chairman LaFalce. In both of those. Done. Thank you very much, Mr. Hiler.

Before we go to the next, let me just make some points based upon some of the comments that Mr. Hiler made and Mrs. Meyers made.

First of all, we are dealing not only with the 1986 reform bill, we are dealing with the Technical Corrections Act, and I did establish the fact that there was no small business or business input on section 89, to our knowledge, into the 1986 Act.

Was there any type of dialogue between the business community and at least the Ways and Means Committee with respect to the Technical Corrections Act provisions dealing with section 89? If so, what was the nature of that?

Mr. Satagaj. Mr. Chairman, if I can answer, I didn't participate in these discussions, but there was a group of business folks—and there is probably a moral to the story——

Chairman LaFalce. Led by whom?

Mr. Satagaj. Basically pension professionals. That's the best way to describe it. I guess the moral to my story is——

Chairman LaFalce. Before you get to your moral, I want to stop you right there. You say pension professionals.

Mr. Satagaj. Yes.

Chairman LaFalce. To your knowledge, what percentage of small businesses provide benefits such as health benefits—I would think it would be a large number—and then what percentage provide pension benefits? I would guess it would be considerably smaller, perhaps in large part because of the unbelievably greater administrative burden in providing pension benefits.

Would you be able to come up with any data on that, or do you have it in your head right now?

Mr. Galles. I can give you an off-the-cuff response. A survey that we just concluded showed an increase in health benefits from 1987 to 1988. In 1987 there were approximately 74 percent of our members that provided health insurance benefits, and in 1988, of those responding to our survey, it was closer to 80 percent.

On the pension side, both 1987 and 1988 were substantially below 50 percent. I think somewhere in the range of 22 percent had pension programs.

Chairman **LaFalce**. You're talking about 22 percent as opposed to 80 percent, and yet I think the mistake that the Ways and Means Committee staff probably made—I doubt that this was a Member making a mistake such as this [Laughter]—was to believe they could create rules for health and life insurance benefits, et cetera, comparable to rules for pension plans. I think that was a fundamental mistake. Your moral, Mr. Satagaj?

Mr. **Satagaj**. The moral is that we probably shouldn't leave it in the hands of the technicians. There was substantial discussion between the private sector and the Hill between 1986 and 1988 relating to some technical changes. What you see from the 1988 act are those revisions.

Now, frankly, at the time we had problems with it even amongst ourselves in the private sector, that perhaps these recommendations weren't going to solve the problems for small business. So that is the moral of the story. We should let small businesses speak for themselves.

Chairman **LaFalce**. I know, when I was a practicing attorney, it was possible for us to provide health benefits for our employees, but we just couldn't come up with a pension plan. There was just a night and day difference between the two. If we had the same rules applicable to the provision of the various health benefits we provided, and other benefits, as we did the pension plans, it would have been impossible.

Mr. Bilbray.

Mr. **Bilbray**. Mr. Chairman, like every member of the committee that has become totally aware of the problem, I kept my powder dry until the hearing to decide whether or not to go on the bill. From the testimony we have heard, I'm on the bill.

Being only a second termer, I have only dealt in a limited way with the Ways and Means Committee. It appears that it is going to be very difficult to get them to undo what they have already done.

Would it be a consideration that there be two alternatives. One, of course, is to try to find a formula to create a threshold where section 89 would exempt most small businesses in this country, because undoubtedly, their taxing staff has determined that by doing what they have done in section 89, they will create billions of dollars of additional revenue to reduce the deficit. So by that standard, we're going to have to go in and argue—and I'm sure that the committee is going to argue—that by removing 89, we are now removing projected income from the Federal revenues and we're going to have to make it up by creating taxes with some other methods.

Chairman **LaFalce**. But, you see, Jim, one of the problems is, the only way they will make money for the Federal Government is if they can create a law that people can't comply with. Because the only way the Government gets money is through noncompliance. The more compliance there is with the law, the more provision of health benefits, the less money the Federal Government makes because you'll have greater deductibility. Therefore, there is an incentive in concocting a law that can't be complied with.

Mr. **Bilbray**. I agree with you. I'm not sure Ways and Means will agree on that.

Mr. **Galles**. Mr. Chairman, there's another side to that. If it costs business so much more to comply, their profits are reduced and, as a result, the tax revenues are reduced. The original impact of the bill—and I apologize for interrupting—the original projection of the revenue impact on the Federal Treasury was $200 million.

Mr. **Bilbray**. The reason I was suggesting this is because I presume this bill will have to go to Ways and Means to be corrected. I was just trying to see if there was any way of trying to retain original jurisdiction within Small Business——

Chairman **LaFalce**. No way.

Mr. **Bilbray** [continuing]. Like limiting it just to small business issues, so that we might not be here 2 years from now arguing with Ways and Means.

Chairman **LaFalce**. We could just limit it to small business and we still wouldn't have jurisdiction over a tax issue. That's exclusively within the jurisdiction of Ways and Means. There is no way that we can concoct a law that would give us legislative jurisdiction. This is exclusively an oversight hearing on this issue.

Mr. **Bilbray**. I was afraid you were going to say that.

Chairman **LaFalce**. Do you have other questions, Jim?

Mr. **Bilbray**. No; you've answered it, an answer I did not want to hear.

Chairman **LaFalce**. It's an answer I didn't want to give.

Yes, Miss Large.

Ms. **Large**. You were inquiring about some of the technical corrections. There was some small relief given to small employers during technical corrections. They lacked substance. But it did allow a phase in for companies with fewer than 10 employees. It seems to somewhat address the question that was——

Chairman **LaFalce**. What's the nature of the phase in?

Ms. **Large** [continuing]. The phase in, in 1989, as I understand it, only employees who work over 35 hours a week need to be included. In 1990, 25 hours a week, and then in 1991, it drops to the 17.5. That's for small employers with fewer than 10 employees.

Chairman **LaFalce**. Good.

Mr. Poshard.

Mr. **Poshard**. I have no questions.

Chairman **LaFalce**. Mr. Sarpalius.

Mr. **Sarpalius**. Mr. Galles, in your statement you stated that the approximate amount of revenue that section 89 would generate is about $200 million. You say in actual fact, however, the cost of implementation and compliance will far outstrip these figures.

Do you have any guesstimate as to whether this will generate any revenue and how much it might be?

Mr. **Galles**. The only revenue I expect it will generate would be the downside revenue from the taxation or the penalties that would apply for noncompliance.

I can't believe that the net revenue to the Treasury would be a positive number. Again, this is a fair comparison to the car logs issue of 1985. At that time, when I testified against that, I remember a figure that was provided of about a $40 billion cost of compliance. If you figure 17 million small businesses in this country with costs ranging from the $1,000 that Miss Large talked about, to

$50,000 to comply, I expect you're probably in the same range with section 89 and its compliance.

Mr. **Sarpalius**. Thank you.

Mr. **Corbett**. I think one thing you have to keep in mind is there is only so much money there. Out of the $36,000 I gather each month, I have maybe $2,000 to $2,500 that I can put in hospitalization. I can spread that among 36 employees or I can spread it among the ones I have now. That's all that's there.

Chairman **LaFalce**. That's a very telling point. You just can't make up that money and create it out of nothing.

Mr. Mazzoli.

Mr. **Mazzoli**. Thank you very much, Mr. Chairman.

First of all, I would like to commend you for your courage in undertaking these oversight hearings. As my colleague from Nevada has said, the Ways and Means Committee has a very strong, lofty, and powerful position on Capitol Hill, and to undertake this kind of a review of the bill that they have passed obviously could cause heartburn in certain quarters. But I commend the chairman.

Also, for the new Members, and for the people in the audience who may not know, the chairman showed that same kind of courage last year as chairman of this committee in having hearings on the minimum wage and its effect on small business, on parental leave and its effect on small business. I think this chairman is the only chairman in the history perhaps of this committee that has really looked at things from the position of its effect on small business. What happens to a Fortune 500 company and what happens to your company are vastly different things. They occur on two different planets. So, Mr. Chairman, I would again thank you for this and urge that you continue.

Let me say briefly—and I have read these articles about how disputed this data is that we have used—that small business creates all net new jobs. I know you've read that debate. But whether it creates all net new jobs or whether it creates 80 percent of the new jobs, or 65 percent of the new jobs, whatever percent, small business is the engine creating jobs in America today. I think it will remain that engine for the foreseeable future, which suggests that we ought not to knowingly do anything that would impede or circumscribe the efforts that you all are making to create jobs.

If section 89 is an impediment—and it would seem to be, from the mail I have received, quite a cascade—and forces small businesses either out of the market or to divert resources, then I think we have to certainly examine it from the standpoint of its wisdom and whether or not it should remain.

I echo to some extent the concerns raised by my colleague from Kansas, Mrs. Meyers, and that is that we want to do the right thing. We don't want to condemn a group of employees to have a second class situation in comparison with the higher paid employees. So at some point probably something like this may have to be enacted. I think probably now it would be wise to scotch this effort and scrub it down and get rid of it and start from ground zero and reconstruct it when you do have the opportunity for small business to make an input. But it does appear to me that there may well be a need at some point of having something like this. So to the extent that the various small business groups, using the lawyers and experts—I share your concern that sometimes too many experts can spoil the broth—should try to think in terms of what could be done, what is a way to guarantee that employees have a shot at this benefit package along with the bosses.

Last, I would also encourage any of us to try to think of ways to prevent this kind of thing from happening again. Any time you have these large bills, like the 1986 act, no one can read every single word, and probably if you could read every word, you wouldn't understand what it was saying anyway. But I do think it points out the need to try to stay away from these magnum opuses and try to get down to fairly narrowly targeted legislation because then you have the opportunity of making the thing work.

So I want to thank the chairman for calling the hearings and to all of you for your forthright statements.

Mr. Chairman, I would like myself to go on both of your bills, for whatever that's worth. We think that might spur at least the debate that this kind of an issue needs. Thank you.

Chairman **LaFalce**. I thank the gentleman for his cosponsorship and for his kind comments.

We now have another new member, a member of the minority side, Mr. Tom Campbell of California. Mr. Campbell, we welcome you to the deliberations of the Small Business Committee.

I don't know if you've had an opportunity to hear very much of today's testimony, but if you have any questions, we would be glad to give you your 5 minutes now.

Mr. **Campbell**. Thank you, Mr. Chairman. I surely will take less than that.

I had an opportunity to read the statements, so though I had a previous committee meeting, I was at least informed by what you have submitted and I am grateful for it. I want to add my congratulations as well to the chairman for holding these hearings. I think it is quite valuable and I echo the words of Mr. Mazzoli.

The only question I would have is one which might be interesting to the panel, dealing with why the imposition of failing to comply with section 89 has to be upon the employee. This is one of the anomalies that suddenly you find yourself paying tax on something that you personally did not choose, and at a valuation over which you had no control. The sanction system seems to be an anomaly.

I can understand from the point of view of the employer, from the small business, that you would just as soon not be the subject of the sanction. So if your answer is "Well, let's not worry about that provision," I can understand it. But from my point of view, it seems to me particularly inequitable and certainly unforeseen, that if you fail to comply, if the employer fails to comply, the burden is borne by the employee. I wanted to know if any of the members of the panel or the witnesses had a comment on that aspect.

Mr. **Satagaj**. Mr. Congressman, there is a penalty for the employer as well, so they did manage to get both sides.

Mr. **Campbell**. But do you think the employee should pay any penalty?

Mr. **Galles**. Basically, I'm appearing today for National Small Business United. Our position is to repeal the whole thing so that neither the employer or the employee pays a penalty because they're both being ambushed. It is a major burden on the employer to have the employee penalized, quite frankly, because if I've got a very good employee in a construction business and I want to keep that employee, and all of a sudden he gets ambushed, paying a lot of Federal taxes because his wife had a baby or whatever, then that employee is going to be exceptionally angry. He is not going to be angry at an abstract Ways and Means Committee or whoever it is in Washington. He's going to be angry at me. That will deteriorate our relationship. So the fact that the employees are being penalized hurts the employees and also hurts the employers.

Our position is, very firmly, that we have to repeal the entire section and eliminate both penalties on the employers and the employees.

Mr. **Campbell**. I thank you. I just in conclusion want to echo again the comments of appreciating the chairman holding hearings on this topic.

Chairman **LaFalce**. Thank you. I think Mr. Campbell's question was prescient and raises a good political point, too, at least implicitly, that we ought to be concerned not simply with the inequity to the employer but also with the inequity to the employee. While the inequity to the employer is one that's obvious to those of you sitting at the table right now, it is an inequity brought about primarily because of the difficulties you have in complying with the administrative nightmare that you must experience. For the employee, it is an inequity borne of illogic. There is no logic that one can conceive of which would impose a penalty on an individual who is innocent of any attempt or lack of attempt to comply with the law. The employee has nothing to do with compliance.

Further, if we are to do something about this law, repeal it, as would be my preference, or alter it significantly, which would not be my preference at all, because I really think the onus should be on the Ways and Means Committee to come up with something correct in the first place, rather than put the onus on us now to act under the duress of this law going into effect unless we exact something that we don't like but might be better than the existing law, it would be good if we could get the labor movement to join with us. They historically have opposed taxation of employee benefits. To oppose taxation of employee benefits that one has negotiated for is one thing; to oppose taxation of benefits that one not only hasn't negotiated for but benefits that come to you with a taint—and you have had nothing to do with the taint—should be particularly obnoxious to the labor movement. You might be able to join forces with them, the quid pro quo being that there has to be an elimination of the sanctions for both and, therefore, repeal. I think you couldn't join forces with them unless they would join forces with you, and together we might be able to do something. So I think the point that Mr. Campbell makes is politically astute also.

If there are no other questions, then the committee will adjourn until tomorrow morning at 10 a.m., when we will have a second day of hearings on this issue. Thank you very much.

[Whereupon, at 11:55 a.m., the committee was adjourned, to reconvene at 10 a.m. the following day.]

EMPLOYEE BENEFIT RULES

WEDNESDAY, JANUARY 25, 1989

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to call, at 10:05 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LaFalce. The Small Business Committee will come to order.

Today is our second day of hearings this week to examine the impact of section 89 employee benefit rules on small business and their effect on the expansion of health insurance coverage.

Section 89, which took effect on January 1 as part of the 1986 Tax Reform Act, requires all employers to conduct a series of complex statistical tests to determine if their employee benefit plans, principally health and life insurance, are distributed fairly among highly-paid employees and average workers.

At yesterday's hearing we heard testimony from business owners and representatives of small business associations about these extremely complicated testing requirements and the onerous compliance burden imposed by section 89.

They stated that the likely effect of the new employee benefit rules will be to inhibit the expansion of health insurance coverage among the working uninsured. Small business owners in particular will be discouraged from offering health benefits and may be prompted to reduce or even eliminate the benefits they now provide.

That is our principal concern here. We all agree that Congress must develop effective policy initiatives to close the alarming gap in health insurance coverage. Any policy directed at the working uninsured must focus principally on the small business sector because that is where the problem lies. The vast majority of the estimated 18 million uninsured workers are employed in small businesses, and nearly half work in firms with less than 25 employees.

I introduced a bill yesterday, H.R. 634, with 45 cosponsors, to repeal section 89. Repeal of the law will give Congress an opportunity to review the potential impact on employers and to examine reasonable, simplified alternatives to achieve the policy goals of assuring fair distribution of employee benefits and expanding health insurance coverage.

That bill, and a second that I will introduce Friday to allow unincorporated business owners a full tax deduction on their health insurance costs, will provide an important incentive for small businesses to offer health benefits to their employees. Our public policy must provide incentives such as these to encourage expansion of health care coverage and, wherever possible, to remove regulatory obstacles that inhibit such coverage.

This morning we will hear more about the problems of section 89 and about possible alternative strategies to accomplish its intended objectives.

Our witnesses this morning are Paula Calimafde, president of the Small Business Council of America; Howard Weizmann, executive director of the Association of Private Pension and Welfare Plans; Richard Raup, chairman of the Society of Professional Benefit Administrators; and Donald Hull, representing the National Society of Public Accountants.

I know that Congressman Conte has a statement for the record and, without objection, we will put it in at this point in time.

[Mr. Conte's statement may be found in the appendix.]

Chairman LAFALCE. Do any other members have statements?

Mr. Skelton.

Mr. SKELTON. Mr. Chairman, I might state that the hearing yesterday was very informative and we look forward to the witnesses today. This section 89 I am sure is a prime example of the law of unintended consequences. I hope we can move forward with your proposed legislation, getting all the facts here today to make an excellent record, to relieve the small businessmen and women of America of this tremendous burden, which frankly doesn't make sense at all, the way it is written, even though it may have a laudable purpose.

Chairman LAFALCE. May I ask all the witnesses to come to the table, please. We will first hear from Miss Calimafde.

TESTIMONY OF PAULA CALIMAFDE, PRESIDENT, SMALL BUSINESS COUNCIL OF AMERICA

Ms. CALIMAFDE. Thank you, Mr. Chairman, and members of the committee, for the opportunity for the Small Business Council of America and the National Association of Women Business Owners to present their views on section 89. The SBCA is a nonprofit, nonpartisan national organization representing the interests of small business on tax matters. NAWBO is a trade association representing more than 2,700 business women and owners around the country. They have 40 active local chapters.

I also had the privilege of serving as a National Commissioner on Payroll Costs at the 1986 White House Conference on Small Business. Payroll costs covered the issues of employee benefits and retirement plans, so I feel I have had a unique opportunity to have heard from many of the small business owners in the country at that conference.

The Small Business Council of American and NAWBO applaud your efforts to repeal section 89. I believe I can state that the entire small business community applauds the efforts to repeal section 89 or, at a minimum, to have major simplification of this statute and a delay of the effective date.

The Office of Advocacy of the Small Business Administration has been actively monitoring section 89 and has been trying to assess the impact of section 89 on the health care delivery by small business to its employees. I have been fortunate to have been engaged in dialogue with the SBA and would also like to strongly show my support for their work and views on this topic.

To this end, I would like to refer to a letter from James Abdnor, the Administrator of the SBA, to Nicholas Brady, the Secretary of the Treasury, dated January 4, 1989. In part, this letter states:

> The burdensome section 89 requirements will further deter small employers from initiating or maintaining health benefit plans by adding considerably to the expense needed to provide those plans. Additionally, small employers will incur this expense without regulatory assurance that they have followed the dictates of the law. At a time when Federal policy is properly focusing on expanding and encouraging voluntary health care coverage, and all employers face soaring health care costs, Federal action which would discourage employer provision of health coverage must be avoided.

The SBCA and NAWBO stand behind that statement.

Now, I come before you in another role, also, which is as a tax lawyer. I can tell you that, as a tax lawyer, I have spent literally hundreds and hundreds of hours trying to learn the intricacies of section 89. The law firm that I'm a member of has spent hours preparing letters to clients, explaining to them what section 89 is, writing memos, trying to explain what they should do.

The other day one of my colleagues said to me:

> How can you go and testify on a statute calling for the repeal when you have put in all those hours and you have the chance to make so much economic gain on this statute?

I thought it was a good question. The reason is because, as a tax lawyer, I believe in the integrity of the tax system. I think that this law is way too complex. There have been studies that show that when complexity increases to such a point, what happens is compliance goes down.

I think this law epitomizes the problem of the last several tax laws, which is that the focus is not on the forest; the focus is not even on the trees. I think it's even nice to say the focus is on the leaves. Sometimes I think the focus is on the nuts on the trees.

We are into micromanagement, and the more micromanagement you get into with tax laws, the more complexity results. As complexity increases, the more you get business owners saying "I'll just take a chance. I am complying with the intent of the statute. I'm not going to sit and write some kind of two-page summary to my employees. The insurance booklet is good enough." There is not much I can say to that client because I have to agree with him. Of course, I have to let him or her know the severe penalties they may be facing.

Having said that, I do think the goals of this legislation are laudatory. I think to try to promote coverage in the health care area is something we have to do, and I personally believe in voluntary incentives. I think the concept that if you don't promote coverage, or you don't provide the coverage to staff, then you're going to be penalized, and that the penalty will be paid by the highly-compensated employees is also a good goal.

I think the statute is too complex, and I say that as an employee benefits attorney. After all those hours and speeches I have given on section 89, I still, in many areas, could not give you an answer as to how you apply the statute, even today.

As you have heard, you know the qualification requirements under section 89 require a written plan, that the plan be legally enforceable for the employees, that the company intends to maintain the plan indefinitely, and that notice be given to the employees.

The penalties I am sure you have also already heard. What I find so unfair about the statute is the penalty where, if the employer does not qualify the plan, then an employee who undergoes—let's say a staff employee who makes $10,000 a year undergoes heart surgery—if the employer did not have the proper written plan, with the proper words in that written plan, then the way the statute is today, that employee will actually take into income the amount of the dollars expended for that heart surgery, which as you know could be hundreds of thousands of dollars.

So here you have a staff employee with significant amounts of phantom income and no source for the payment of that tax. The problem is there is no culpability on the part of the employee here. It is because the employer did not take the required action.

Now, the problem is particularly acute because many small businesses, in my opinion, aren't even aware of section 89. There has not been a great effort on the part of the Government to disseminate information. As you know, regulations are still not out. I will give you one short example in this area.

Section 89 today, the way it's drafted, requires that notice be given to employees the first day of the plan year as to what their benefits are under the statute. We have been told by a Treasury spokesman at an employee benefits conference here in town several months ago that the notice requirement is going to be delayed in the proposed regulations and that it would be either March 31 or the first day of the plan year, whichever was later.

A couple of weeks ago another Treasury spokesman at another employee benefits conference here in town said the proposed regulations are going to push that date back and now notice doesn't have to be given until the first day of July or the first day of the plan year, whichever occurs later.

Now, that is hard enough for an employee benefits attorney in Washington to follow, but if I were a business owner in Billings, MT, I don't know how I would know that someone in Washington was saying that the effective date of this notice requirement was going to be postponed. Worse, if the proposed regulations don't defer the effective date, then my guess is there's going to be a lot of small businesses out there who are already technically in violation of section 89. Assuming, that is, the regulations are drafted in such a way that the insurance booklet isn't good enough to give employees' notice. So as a practical matter, even on the basic requirements themselves, we do not have enough information as to what is required to be in them, what is the effective date for them, and how to deal with them.

I think it is safe to say that almost all employers are confused about section 89. I am sure most small business employers are. I know many companies have expended tremendous amounts of dollars to bring these plans into compliance with section 89, and those expenses have already been incurred, which makes this problem even harder. But the timing requirements, the penalties, the administrative costs, and the outside consultant costs are high and employers are confused and angry about them. I'm sure you have heard that.

A problem with section 89 is that an employer can provide what he or she deems to be nondiscriminatory coverage, and because of employee choice, it can turn out that, in fact, the plan is discriminatory. Companies cannot quite accept why, when they are providing a plan which is nondiscriminatory in a normal sense, that, in fact, after you apply the section 89 test, the plan turns out to be discriminatory.

Chairman LaFalce. Could you explain that a bit, by example?

Ms. Calimafde. You can have a plan where a company offers an HMO option, and it offers a Blue Cross/Blue Shield option—I'll try to make this as simple as possible. The employees have to contribute to the cost of these two plans. The employer cost is the same. The employee cost is very different, let's say a difference of $1,000 a year. Depending on how you go through these various section 89 aggregation tests, you may end up in a situation where, even though the company is providing the same amount of dollars to the employees, and it's the employees' decision on which plan they want to pick, in fact, the overall employee benefit health care delivery is deemed to be discriminatory under section 89 and the highly compensated employees will have to pick up a portion of the cost in their tax. That is something companies have a hard time trying to assess why they're being penalized because they have given the employees a choice as to what health care system they preferred.

In this regard, the new rules that came in under TAMRA, which significantly changed these aggregation tests, attempted to make some of the tests easier. But by building on various safe harbor tests, they are now so complicated that I would not be able to sit down today and run through a section 89 problem for a company that has, say, 15 or 20 different plans. It would take me some time to analyze what each plan had and then to work through these various aggregation tests. In fact, a lot of experts are relying on software to do that. They have more or less given up on trying to do it themselves.

That goes to the complexity in the area. Small businesses in general have a harder time with the whole statute because they have a higher per capita cost in the health care area. They have higher employee turnover. They traditionally have a higher number of what would be deemed to be key employees, and they use part-time employees and older employees more commonly than larger companies. So the administrative costs for the small businesses are going to be greater, and they also don't have the luxury of in-house administrators to determine how the section 89 tests are going to work, so they are basically going to have to hire an outside person to work through all these rules and tests. Then they are going to have to pay the high costs which take away from the competitiveness of the business.

In summary, I would like to say that NAWBO and SBCA are for the repeal or the major simplification of section 89. Because of the significant complexity of the statute, the lack of experts in the country on this code section, the Draconian penalties imposed upon the employees, with no culpability on their part, and the lack of information that has been disseminated to the public, I think that it is highly desirable to have repeal or, at a minimum, a significant delay in the effect of the statute and time to simplify it.

But absent outright repeal or major simplification, which is what we consider most desirable, we would call for the following at a minimum. All penalties be delayed for at least 1 year and that the penalty imposed on the employees due to lack of qualification on the part of the employer be eliminated entirely. If there is going to be a penalty, it should be imposed at the employer level, not at the employee level.

A 6-month relief period granted so that employers can properly collect the data they need and determine the best structure for their health care plans and that any changes they make in their health care plans at this time not be counted under section 89.

Most importantly, I think, a study should be undertaken to see how the discrimination rules can be streamlined and be brought more in line with the retirement area so that concepts which were borrowed from retirement plans can be brought over to the employee benefits area. A very simple example on this is that in pension plans, or qualified retirement plans, a part-time employee is deemed to be someone who works less than 20 hours a week. So a company that has a pension plan already has data on who works less than 20 hours a week.

In section 89, a new standard came out which was 17.5 hours. That is one more adjustment in all the records to find out who qualifies under the health care plans as compared to the qualified retirement plans. I think the 2½ hours, one way or the other, is not the significant issue; just that there be one standard applied.

Chairman LAFALCE. Considerably fewer private small employers would have pension plans, as opposed to health benefits plans. I guess that is basically correct.

Ms. CALIMAFDE. I think that is true, yes; but there are a large number of small businesses that do sponsor qualified retirement plans and who are keeping those records, but that is true, particularly when you get into the sole proprietor and partnership area. Small business is a very nebulous concept. It goes from corporations to mom-and-pop stores to high-tech industry so——

Chairman LAFALCE. Thank you very much, Ms. Calimafde.

Ms. CALIMAFDE. Thank you.

[Ms. Calimafde's statement may be found in the appendix.]

Chairman LAFALCE. Our next witness will be Mr. Howard Weizmann, the executive director of the Association of Private Pension and Welfare Plans.

I noticed that he is accompanied by counsel, Mr. James Klein. If Mr. Klein wishes to take a seat, he is more than welcome.

Mr. WEIZMANN. He whispers good advice, I assure you.

TESTIMONY OF HOWARD WEIZMANN, EXECUTIVE DIRECTOR, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS; ACCOMPANIED BY JAMES KLEIN, COUNSEL

Mr. **Weizmann**. I am pleased to be here as executive director of the Association of Private Pension Plans, an association representing more than 400 large and small employers, insurers, as well as benefit consultants. We have been in existence since 1967, which gives us a great deal of credibility, at least in our view, with regard to issues that affect employee benefits.

I am also pleased to be here because I am probably the only one who represents a major trade association who was actually an employee benefits manager at the time that section 89 was passed. So I feel that I speak with special fervor concerning this issue.

Ostensibly, section 89 has three purposes, all of which you have heard before, but let me restate them. First, it is a nondiscrimination statute. It attempts to incorporate into the statute standards that were originally applied in the pension area dealing with nondiscrimination in favor of highly compensated employees. Our national definition of highly compensated employees is basically everybody earning over $50,000, provided they fall into the top 20 percent of their employee population.

Second, that statute ostensibly intends to increase coverage by providing that certain tests will not be passed unless you count large numbers of part-time employees and large numbers of your actual workforce.

Third, the statute—and forgive me for saying this with a little chuckle—is intended to promote tax efficiency. These are standards that in fact, when taken either singly or collectively, sound very noble, but one notes, as Mae West once said, "I started off as Snow White, but then I drifted."

Unfortunately, as you have heard before, the statute is overly complex, and I won't dwell on it except to say that I have brought with me a flowchart which is 11 pages long and contains some 70 boxes involving some, I am told—I have not sat down and counted them—some 50 or more decisions to be made by an employer, large and small, as to whether compliance can be determined.

This is expensive. These kinds of determinations cost money; they cost large businesses hundreds of thousands of dollars and they cost small businesses tens of thousands of dollars, neither of which are in a position to afford such additional costs when, in fact, health care costs in general are eating everybody's lunch.

Treasury has purported to relieve this burden by finally issuing regulations. We are told they will come out in another month. We are also told that those regulations are double-spaced, and I will give them that, it is double-spaced. They are 230 pages long.

They deal with transition rules, principally, and general rules regarding section 89. They do not deal with the principal areas of evaluation, lines of business, et cetera.

I ask you, and this is a rhetorical question because I know the answer and I hope you do as well, whether 230 pages of regulations simplify anything or make things a little more complex. For small business, this is an incredible burden, but it is also an incredible burden for large business, both of whom must pay for this extra because nobody has the necessary expertise in house.

With regard to the objectives of the statute, I would like to say that they are not reasonably obtainable. Simply, if we were talking about the pension area, people are talking about significant benefits. For instance, pensions permit payments of up to on the defined benefit side over $90,000 and the defined contribution side of contributions of around $30,000. Therefore one could reasonably assume that the candle of distributing benefits was worth the fire of rules used to light it.

Quite frankly, with regard to section 89 we are talking about a benefit that causes the imputation of only about $3,000 worth of income to highly compensated employees. The notion that suddenly employers will slap their heads and say, "Excuse me, we made a mistake and we are going to extend our benefits on a nondiscriminatory basis simply because I have to impute $3,000 of income to me" is absurd. In talking with employers around the country, as I have, I find that employers would much rather impute the income to themselves and not change their plans, whether they are discriminatory or not.

Second, with regard to coverage, the same issue applies. Will $3,000 worth of imputed income cause employers to extend coverage not only to part-timers, but also to their employees in general when they have not done so before?

Small business and large business, in a lot of cases, cannot afford to extend such coverage. This issue is being debated currently by Congress, as I am sure all of you are aware, and we applaud the positions taken by this committee previously. However, the notion that simply imputing $3,000 of income under section 89 will both cause the nondiscrimination standards to be enforced, or second, cause additional coverage is patently absurd.

Third, I want to talk a little bit about the tax efficiency of the statute. Let me relate a story if I might. One of my consultant members informed me that one of his clients—and this is not an atypical example—spent $60,000 with him to find out that he had to impute $4,000 of income. Again, a question, is this tax efficiency?

I am told that with regard to the notion of tax efficiency, the idea is that they want to make sure that the actual benefit gets fairly distributed across the board. As I said before, I don't believe it will happen with regard to nondiscrimination. I don't believe that it will happen with regard to coverage.

Fourth, is it tax-efficient to apply the section 89 rules to ensure that a $3,000 benefit gets distributed evenly? We don't do this in other areas. For example, we have no nondiscrimination standards for the inside buildup for $2,000 contributions and really provide approximately the same dollar benefits. Why is health care different in this instance than IRA's?

The statute, as currently written, is unadministerable, both from an employer's standpoint and, quite frankly, from the IRS standpoint. Data collection in this area, quite frankly, is suspect. One employer, a Blue Cross Blue Shield person out in the Midwest, informed me that 23 percent of all data responses to a section 89 census issued in the locale were—let me just say—inconsistent with those previously on file.

Employees, at least, are very sensitive about collecting this kind of data, are always concerned that an employer is trying to coordinate benefits and somehow delete their coverage. In sum, employees believe it is in their interest to not to correctly report dual coverages.

Section 89 will also have an adverse impact on health care, and I think that needs to be emphasized again and again because this is a real shame. At a time when medical inflation is approaching double digits, and employers are looking at various kinds of mechanisms to introduce flexibility and choice into the system to hold the line on costs, section 89 provides an incentive to structure plans which are in a sense simplistic, one-benefit level, noncontributory plans—plans that employers have moved away from in the past.

Let me cite an extreme example just to illustrate the point, and I recognize it is an extreme example, but it gives you an idea of what Congressman Skelton was talking about, the law of unintended consequences.

As a benefits manager, we had an individual who called from a local hospital who was ready to go in to be tested as to whether that individual would qualify for a heart transplant. Unfortunately, that individual had signed up with an HMO and not our indemnity plan and the HMO did not cover heart transplants. We wrestled with the decision as to whether to simply extend coverage under the indemnity plan so this individual, in effect, could save his life.

These are the kinds of decisions benefit managers who typically deal in dollars and cents are not particularly comfortable with, but certainly they make them and they are forced to oftentimes.

Most likely, we would have extended coverage. Unfortunately, that individual died that afternoon—not while they were waiting for us to decide—but died as a result of complications that arose at the moment.

However, the absurdity of section 89 is since the individual was not notified as to what his benefits were in that instance, regardless of whether that individual was highly compensated or not, that individual would have been taxed on the benefits used to provide a heart transplant. The notice requirements in this instance work against the kind of coverage that sometimes you find yourself making hard decisions.

Of course, we would have provided the benefit to the individual, regardless of tax consequences, but unless life-threatening circumstances were involved, section 89 acts as a great deterrent toward flexibility and choice.

Flexibility—every time you increase options to employees, quite frankly, some employees would rather have cash than health care and would rather choose a lower option medical benefit. Section 89 imposes a whole new set of burdens on employers that they must test.

Chairman **LaFalce**. Mr. Weizmann, were you involved in the negotiations over the passage of section 89?

Mr. **Weizmann**. No; I was not directly. I was involved, actually, in negotiations concerning the pension side. We lost there, too.

Chairman **LaFalce**. But not section 89?

Mr. **Weizmann**. But not section 89. I can tell you a little bit of the history, if you would like.

Chairman **LaFalce**. I think that might be informative.

Mr. **Weizmann**. This, again, is related as to what I know, and I will be brief and try to avoid editorial comment or snicker every once in a while.

Basically, as you recall, Treasury I and Treasury II, both sought to tax employee benefits as an approach toward raising revenue and balancing the vast changes involved in tax——

Chairman **LaFalce**. One from the top up and one from the bottom down, as I recall.

Mr. **Weizmann**. The first one was a cap and the second one was top up.

But the notion was in the Treasury to tax employee benefits, and we and others had to defend the principle of excluding income from individuals and, quite frankly, I think Treasury would have——

Chairman **LaFalce**. The benefits were the premiums the employer paid, rather than the benefits being received, but not $100,000 hospitalization cost. It was the $1,000 premium that would be taxed. Correct?

Mr. **Weizmann**. That is correct. But the idea again was in base-broadening and the notion of horizontal equity, the argument was being put forth, as you will recall, that individuals who don't have coverage in effect pay for those who do have coverage through the tax incentive system.

Our argument, and I think quite properly, is that we are not talking about a pension benefit where you have 60 percent of coverage. In the health care area, you have almost 90 percent of coverage and it is simply absurd to say that 10 percent of the population supports 90 percent of the health care benefits.

We were able to at least win the argument, although now facing section 89 we asked ourselves what we won. As a result of the fact that Treasury I and Treasury II were not acceptable in either of these areas, the Congress—a staffer confided in me—and I don't know whether this was true or not, but he did say we created rules which will make you wish we had taxed employee benefits.

I am a cynical optimist so I am not sure that is actually true. But with regard to the statute, that is where Treasury was going and that is where we, in effect with section 89, wound up. The original rules proposed in the House were actually much simpler. I don't remember exactly what they comprised, but we were talking about a set of rules that tested principally eligibility and tried to create rules which would get at what they called executive-only plans, which are plans covering only the principals in the business to the exclusion of others.

Chairman **LaFalce**. Are there ways to get at executive-only plans that are fairly simple and deal with that form of discrimination, as opposed to the approach that was taken in 89?

Mr. **Weizmann**. As you know, our statement says that we do not oppose section 89's principles, per se. One rule that is contained in section 89 that makes sense—not to throw the baby out with the bath—is simply the 50 percent eligibility rule, which says that 50 percent of your nonhighly compensated people have to be eligible for a plan for which your highly compensated people are eligible.

That test is really focused at executive-only plans and I think since it is an eligibility standard, rather than a coverage standard, the standard is much more easier to implement and enforce.

Second, the scope of section 89, with regard to—it covers Congress, it covers the Federal Government, it covers private employers and public employers across the board—is enormous.

In terms of actual benefits——

Chairman LaFalce. It covers Congress? If we were independent businessmen and we had, say, 18 employees—I think most Congressman have 16 to 18. I can imagine the nightmare we would have if we had to provide this type of health coverage our 16-18 employees and had to go through these mental gymnastics.

Mr. Weizmann. That is right and undoubtedly you would have to go to a consultant who told you what those gymnastics would require and that would cost you money. I am in an unusual position because I also run a trade association which has eight employees. I also, having come from a large employer with almost 20,000 employees, now having to seek the same kind of benefits expertise, although I have a little bit more knowledge probably of the statute than most to comply with the statute.

Chairman LaFalce. Mr. Weizmann, I think we have run out of time. We should go to our next witness before we have questions. Thank you very much for yours.

Mr. Weizmann. Fine.

[Mr. Weizmann's statement may be found in the appendix.]

Chairman LaFalce. Mr. Richard Raup is chairman of the Society of Professional Benefit Administrators.

Mr. Raup.

TESTIMONY OF RICHARD A. RAUP, CHAIRMAN, SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS; ACCOMPANIED BY ANNE C. LENNAN, DIRECTOR OF RESEARCH

Mr. Raup. Mr. Chairman, thank you for the opportunity to be here. I would like to introduce with me today, Ann Lennan, who is our director of research for the Society of Professional Benefits Administrators here in Washington. Hopefully she will be able to help me answer any questions you have on some of the details later on.

I would not like to read the prepared text, but hope it will be entered into the record.

Chairman LaFalce. All the prepared text will be entered into the record. Without objection, so ordered.

Mr. Raup. Thank you. I would like to review several items and start with congratulations and good luck to you on your introduction of the repeal of the 89 bill. But again, being somewhat of a realist, we know that we have had to make some compromises along the way and have some specific suggestions that we would like you and your committee to consider.

Before I do, let me say that I am wearing several hats today. One is chairman of our national association and, again, our association of third-party administrators are professional hands-on benefit administrators. We work in specialty areas of paying benefits claims, the administration of health and welfare plans, health plans, cafeteria plans and, in some areas, pension plans. We work in that capacity much like the CPA's and attorneys do in their specific areas.

I am also the president of my own firm, Business Administrators and Consultants. We specialize in the health benefits area for about 400 small- and medium-sized employers in our State, which is Ohio. About 80 of those groups run from 25 to 400 employees. The rest of them are all very small employer groups.

The third hat I wear is that of a small employer. We have 31 people who work in our office; 15 of them are full-time; the rest are part-time. Now I look at those part-timers with a different set of eyes. Six of those do work every week more than 17.5 hours a week. Four more work considerably less than that, and the other six are high school students who come in after school and help us out with some of the other tasks of getting the mail and files and that type of thing put away.

So I hopefully bring to this committee some ideas and questions that we heard, not only in our own organization, but from those groups that we work with.

The eight specific suggestions that we would like you and your committee to consider, we believe do address the question that you asked in having this hearing, and that is, how can we help not only provide new coverages to the rank-and-file employees, but maintain those coverages, especially in the small business area?

The first is to eliminate—as some of the other panelists have suggested—the tax penalty that is imposed upon the worker. It is grossly unfair to have the worker pay a penalty when all they have done is have the bad luck to work for an employer who somewhere along the line messed up one of the five qualification rules.

It is not only unfair, but I think it is going to lead to an awful lot of litigation of employees turning around and suing those employers for that tax money back.

The second area would be to eliminate the fines that are imposed under the five qualification rules when the fine is the result of a technical error. In other words, we think that those employers who have gone out and attempted to qualify their plans in the five areas should get somewhat of a break over those who maybe have, through ignorance or through total disregard for the law, have not tried to comply at all.

If what we learned with COBRA is an example—when somebody terminated and you get the proper notifications out—what we saw happen there was that those employers who attempted in good faith to comply with the COBRA rules were the very employers who had all the documentation on hand to show that they were not in compliance. Those employers who did not comply with COBRA, didn't even try to, had no records to go back and show whether they, indeed, were or were not in compliance. I think we can see that happening as many small employers in their own good-faith abilities, try to bring their plans into qualification under these five qualification rules.

The third area——

Chairman **LaFalce**. Let me just interrupt you for a second.

Mr. **Raup**. Sure.

Chairman **LaFalce**. I want to understand this in the real world. So I am an employer. I have 10 employees. I want to give them health benefits. What do I do? Who do I go to? How do I go about it? Who do I ask what?

Mr. RAUP. Heretofore, you probably got a hold of your local agent, insurance agent or representative and said, "I need health benefits for my group," and he would either bring back a particular plan for you to sign up and may, indeed, bring back several for you——

Chairman LAFALCE. I would say, "Look, I want to be generous; I don't want to be too generous because I can't afford too much."

Mr. RAUP. Right.

Chairman LAFALCE. He will say, "How much can you afford?" I want to say, "There is no way I can afford more than $1,000 a month in total."

Mr. RAUP. To take that as an example, he comes back with a plan and says, "Gosh, you can sign up with this nice comprehensive benefit plan." It might be through the Blue Cross. It might be through Prudential, but most likely a fully insured type of a product and the price that you would pay for single coverage might tally up to be $1,000 a month. For those who wanted family coverage, you may say, "Fine, if you'd like to pay the additional cost for dependent coverage, then, as an employee, you can make that payment as a payroll deduction."

That would be the very typical situation of how most small employers have their health benefit coverages taken care of today. Probably more than most are that way with one plan.

Chairman LAFALCE. How does this change that?

Mr. RAUP. First of all, in the five qualification ruling areas, you are asking that employer to provide a written plan, a plan document, if you will, which, again, hoping the regulations give us some guidance, but we can only perceive it to look much like you see a written plan would be under the pension and profit-sharing arena.

That is a terrible burden for a small employer who is not——

Chairman LAFALCE. Wouldn't an insurance company do that?

Mr. RAUP. There is no law that I know of that says that the insurance company is supposed to do that. This is an employer-based law. If the employer signs up for this plan, he may assume that his policy is a written plan, but we have no way of knowing whether or not it is going to meet——

Chairman LAFALCE. In the real world, isn't it a written plan almost all the time and the insurance company would provide—Blue Cross/Blue Shield would give it to you and say——

Mr. RAUP. In most cases, that is correct. In fact, it is there somewhere, even though it may be not easy to grab. There is a written plan or a policy that justifies that.

Now, the problem you have—or at least that we are concerned about—is the employer who adopts that and says, "That's my written plan." That policy, which again, in most cases is controlled by the State insurance laws where that employer is located, may not have all the bits and pieces that it is supposed to have in that plan to make it a written plan, as is required under section 89.

Where the real error we see happening is an employer who says, "OK, I'll write my own plan. I'm going to say to my employees, 'Gosh, you work for me; you get benefits. Once you've been here 30 days, you're eligible to sign up and here's how the benefit plan works."

The danger, I think, is that now the employee really has two plans in hand. He has one from the insurance companies that says, "Here's your benefit plan," and another one that the employer has given him because he has to under section 89. The employee has a claim, submits the claim to the insurance company or Blue Cross and they deny the claim, say, "No; that's not an eligible expense," or, you know, "That's a preexisting condition. We don't cover that."

The employee says, "But wait a minute, I've got a plan here from my employer. It's a written plan. It says I've got benefits."

We now put the employer in the middle of a rock and a hard spot between the employee saying on the one hand, "I've got benefits because your plan says so," but the insurance carrier who actually is the decider on where the benefit payments will be paid and where they won't be—is saying no. What gives?

Again, I think we create another situation for our already overburdened courts to handle more litigation.

Chairman LaFalce. Could you try to summarize briefly now?

Mr. Raup. I sure will. Two other areas—there are several other areas—I will skip over some, but in the testing area itself, where an employer establishes a plan and that plan is inherently nondiscriminatory by the way it is set up; in other words, the employer says, "If you work here, you get benefits and I'm going to pay the lion's share of those benefits, the cost, the premium cost," then why burden that employer with having to go through the effort of testing when just the very way the plan is set up, it is nondiscriminatory? It is very, very expensive.

We have seen prices range from small plans, entry levels, to get discrimination testing done at $3,000 to $4,000. They range upwards for the larger groups. When you look at an average cost per employee, I think it is reasonable to anticipate throughout the country that it is going to run about $50 per year per employee.

If you take that times the working population out there, there is a whole new cost to benefits that is going to be in the $4.5 to $5 billion range. That is a cost to employers coming out of the economy that has raised not one nickel's worth of revenue yet for the Federal Government.

If, as a result of those tests, one out of 20 may incur additional income that creates another $200 to $250 in tax revenues, that would pump, if my math is correct, another $1 billion back into the Treasury.

But small employers, especially, are asking, "Why should we spend $5 just to give you one more? If you need revenues, say so and let's be up front with it. We'll give you a buck and go on about our business."

Chairman LaFalce. Thank you very much, Mr. Raup.

[Mr. Raup's statement may be found in the appendix.]

Chairman LaFalce. Our next and last witness is Mr. Donald Hull, on behalf of the National Society of Public Accountants.

Mr. Hull.

TESTIMONY OF DONALD R. HULL, REPRESENTING THE NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

Mr. **Hull**. The National Society commends you, Mr. LaFalce, and the committee, for holding this important hearing. We especially are gratified that you have entered this bill for repeal and hope that you are successful in its endeavor.

I, myself, am an enrolled agent. I am an independent accountant in Westminster, MD. The National Society represents over 23,000 independent practicing accountants, of which 8,000 are enrolled agents. Our members provide accounting, auditing, management consulting, financial planning, and tax planning to over 4 million individuals and small businesses.

I think the question that you asked earlier can be readily answered; that is when a small business person has a specific question in reference to what type of things he can give to his employees, who does he turn to? The first person he comes to is his accountant.

The accountant serves as everything from father-confessor to tax adviser. We know more about this individual financially than, in many cases, he knows about himself.

When they want advice as to: What to get into; what they can afford; and what they can't afford, they come to us and we, in turn, refer them on to the insurance agent or the pension planner, depending on the type of plan that we feel they can afford for their business.

Section 89 has become so complex, as we've all heard—and I won't be redundant in going over this again—it's creating an intense burden not only for the small business person but also for the independent accountant. Most accountants, be they CPA, enrolled agent, or tax practitioner, do not have the expertise to completely make themselves aware of such a law. The additional burden would certainly be passed on to the individual at an incredibly higher cost, as we have heard from previous witnesses here.

It was apparent that section 89 was created to promote uniformity in providing health care. I think that it has absolutely gone the opposite direction, it is now creating a barrier. Small business owners are being deterred from offering it, because when they come to someone such as one of our members and they ask what the cost is going to be, they find out that if they inadvertently violate even one of these five qualification requirements, there are just tremendous penalties that will result. It just seems that section 89 will actually scare small business away from providing benefits rather than giving them an incentive to providing any benefits.

The mechanics of compliance on this thing, as I said before, are completely beyond comprehension for the small businessman. If you have thousands of employees, it may be easier to comply because you have a benefits section that actually does this work for your firm. However, if you look at the local butcher or the local gas station owner that has a half-a-dozen or a dozen employees, the cost and the time involved are just horrendous. It just seems beyond comprehension.

Ironically, we find that—and you have addressed this by your companion bill here—the small business person, who is extremely wealthy in most cases, cannot even have health benefits for themselves or their family. Further, they only get to deduct 25 percent of this on their personal income tax return and not even one penny on their business tax return if they're a sole proprietor, a partner, or an S corporation stockholder. If they have their own regular C corporation, then they could provide this benefit, obviously, to themselves. Hopefully, the bill which you propose will have some impact.

We commend you for your efforts in trying to create some equity in this area, something that I think is drastically needed.

It is NSPA's pleasure that the House Small Business Committee has invited the National Society to testify, and we stand ready to help in any way that we can, be it for implementation or guidance.

It's very interesting. I just received in the mail yesterday an advertisement from CCH, which is the Commerce Clearinghouse one of the recognized leaders in the publication of tax manuals. This particular ad promoted a series of tapes on section 89 compliances for $475. Their cover sheet on this shows a snake getting ready to take a bite out of you. For CCH to promote section 89 in this manner, I think gives you an idea of what is generally felt about its ramifications. In addition, the Nations Business has gone into depth in their February issue called Benefits Blunder. They have quite an article in there.

As a sidelight—which has nothing to do with section 89—we also have an excellent article on Buffalo's rich baseball legacy. They're coming for a major league team in the area. I thank you, sir.

[Mr. Hull's statement may be found in the appendix.]

Chairman LAFALCE. I'm glad we ended on a very positive note. [Laughter.]

I have a great many questions, but since I also asked questions during the course of the hearing, I will defer mine and go to Mr. Ireland.

Mr. IRELAND. Thank you, Mr. Chairman. I have not so much a question as a brief comment.

I think yesterday's hearing and today's hearing have shown the scope of the problem, and we certainly have a wealth of information to support your legislative initiative. I commend you and certainly hope we can get some quick action.

I noticed a comment in Mr. Weizmann's testimony, just a simple sentence that I think sums up what we face here and the larger problem that we have to face with the IRS, and the fact that they are not required to participate in the regulatory flexibility process. Mr. Weizmann says in his comments, "To get around the lack of any precise data concerning these issues, Congress simply enacted section 89, placing on employers the burden of proving nondiscrimination."

I think for the last 15 or more years we have gotten into the habit in Congress of just indiscriminately placing on employers everything from immigration responsibilities to section 89 responsibilities. It is time we woke up and let the agencies know, as well as ourselves, that American free enterprise is great but they can't do all the social engineering that the Congress would like.

I commend you for not only this but for the whole thrust of changing directions, Mr. Chairman. That's my total comment.

Chairman LAFALCE. Thank you very much.

Mr. Bilbray.

Mr. BILBRAY. I would like to make a comment, too. First of all, I wasn't a Member of the 99th Congress that passed this albatross, thank God. The testimony certainly of yesterday and today has been very enlightening and that's why I went on the bill with the chairman and will be very supportive. I think that anyone who has heard this testimony will agree that you have done a great job, both the witnesses today and yesterday. You have to feel that this section should be repealed, and hopefully the Ways and Means Committee will see it the same way that Small Business Committee does. Thank you.

Chairman LAFALCE. Mr. Ireland and I were consulting about something very important, baseball in Buffalo.

[Laughter.]

Mr. Slaughter.

Mr. SLAUGHTER. Mr. Chairman, I just want to make a comment. I think this section, as has been stated, should be repealed, and then we should go back and look at what sort of situation we should have with respect to these benefit plans, that we start afresh and start anew, instead of trying to take a very complicated measure, which has caused a lot of trouble. I think that ought to be repealed as the first order of business. I am supporting and a cosponsor on the chairman's bill.

Chairman LAFALCE. Thank you very much, Mr. Slaughter.

Mr. Poshard.

Mr. POSHARD. Thank you, Mr. Chairman. As I listened to the testimony yesterday and today, obviously there are some great problems with section 89. But it seems that everyone who has spoken has in some way or another indicated that the goals of this legislation at least are laudatory, that the focus is correct, but that there is—I believe your terminology was we're into Government micromanagement here. I think I agree with you on that, that at least the mechanical nature of this bill is out of sorts and probably ought to be changed.

But there is the real problem of 37 million people in this country having no health insurance, about 18 million of whom are working people. If, in fact, we are going to attempt the repeal of this type of legislation, where the intent as all agree, I think, is good, I would like to know what kind of incentives you feel are appropriate.

Mr. Chairman, the second bill you have introduced brings about some of those incentives, or at least tries to, in the form of tax deductions—if Government is going to be involved in this process, what kinds of incentives from the small business perspective should we be allowing you to at least encourage you to help insure those people who are not insured at this point in time? What is it you need from Government that is not detrimental but would be encouraging and helpful to you?

Mr. HULL. I think the marketplace will take care of itself. I think the deductibility of the proprietor or partner is certainly an incentive. I myself have 21 employees. I am a sole proprietor. I cannot deduct one penny of my health insurance or major medical on my schedule C. I do provide it to the employees, as high as close to $5,000 for an individual that's married with family coverage.

But I think the mere fact of making it a deductible or keeping it a deductible item will encourage most employers to offer it, because it is something if it's not offered by one employer, you're not going to get the quality person to come as an employee. So basically the marketplace will take care of itself. I don't think that the same holds true for mandates and/or this type of regulation. I think that such efforts serve to just push it back further rather than encourage.

Mr. **Weizmann**. May I just say a few words? With regard to the statute itself, or tax incentives in general, I think we need to understand what we're asking the tax system to do by way of incentives, and then define what can reasonably be accomplished, and then ask ourselves what do we do about the remainder.

When you say 37 million are uninsured, that is not to say that they do not receive health care. Congress has done studies which demonstrate that, in fact, health care is extended to those folks, albeit inefficiently.

That said, section 89, as an attempt to get to extend coverage is a very feeble attempt to try to correct something that we need as a Nation to come to grips with. If you ask yourselves whether the incentives provided hitherto have been successful in extending coverage—and I agree with my colleague over here, who has indicated we need to, certainly with Congressman LaFalce's bill that deductibility across the board uniformly needs to be instituted in the system—the answer is clearly yes. The present tax incentive system has already built a system that covers 90 percent, some 132 million people in this country. Further incentives for trial programs could certainly be extended—such as multiple-employer trusts—which might increase coverage. However, the tax incentive system can only accomplish so much. When you get beyond what can reasonably be accomplished through tax incentives, I think we need to justly start talking about either safety nets or other kinds of mixes between private and public institutions in terms of providing those benefits in the margins where people are not now currently covered.

But I think we have run a danger here in saying the tax system needs to be focused on covering every single last person in this country. I think we make a mistake when we try to make it do that, because when we do, we wind up with things like section 89.

Mr. **Raup**. If I may, I think there are several issues that need to be addressed, as some of the other members of this panel mentioned.

When you look at where health care is going and what we need, as you asked, to keep it going, we need to get the focus back on long-term issues as opposed to short-term issues. What has happened in the last 8 years with the variety of benefit bills that we in our industry have been forced to deal with is, we have had change after change after change year after year after year.

One of the biggest blows in terms of taking where we were in long-term planning for our employers to short-term was DEFRA. It eliminated the funding availabilities of being able to set aside moneys to adequately fund plans to pay for claims in the future. It put us on a short-term deal.

Even insurance carriers have been forced to look at short-term in their planning of providing benefits, whether it is for the small employer either through an association plan or a multiple-employer trust. It is a topsy-turvy world. There is no incentive for the employer to set aside funds either in his own plan, or through an association, or through a MET in a long-term program to give it any funding stability and make that plan continue to work.

It is complicated all the more by the fact that you have most insurance companies in most plans operating in multistates, and every State seems to have its own set of mandates that have to do something one way in this State and another way in another State, and they are changing these very rules it seems like almost daily as we try to deal with these within our plans.

So the ERISA preemption issue, I think, is one that maybe needs to be readdressed and reevaluated not only on self-funded plans but looked at a little broader speaking in terms of how we put these benefit plans together.

I really don't think that we need a major overhaul or new system or national health care system from Congress to get this done. A nudge would be great, a nudge that said, "Hey, we're going to stand behind you, the industry, for a long-term pull," and, like you have asked, "What do you need to get it done?" Let's set it up, and let's let it run, and let's quit messing with the recipe every year. It seems that we get a new recipe, and about the time we get it flavored the way we want, we get a new recipe to try out.

That is not a specific answer, but we have been reacting to change year after year after year with these very benefit bills, and I think if we could get back to focusing on where we need to be long-term, we could spend our time and effort between providers and carriers and administrators and you all up here on the Hill getting that done.

Chairman **LaFalce**. Any further questions?

Mr. **Poshard**. No; thank you.

Chairman **LaFalce**. Mr. Hancock.

Mr. **Hancock**. Mr. Chairman, prior to January 3, I was a small businessman. I did not run for the U.S. Congress just for the purpose of repealing section 89.

Mr. **Raup**. We would have supported you.

Chairman **LaFalce**. You just wanted to avoid it.

Mr. **Hancock**. I support it. I support your bill on equalizing the tax treatment of the health premiums. I also would like to suggest, one of the reasons that I specifically wanted to serve on this committee is, I would like to see the committee get involved in areas in support of reduction of paperwork, especially directed to the small businessman. He is being inundated by Government regulations in many areas. After all, they are the key to job opportunities. In many cases, that is where the jobs are being created.

I appreciate the effort that you are making here, and I commend you for it. Thank you.

Chairman **LaFalce**. Thank you, Mr. Hancock.

Mr. McNulty.

Mr. **McNulty**. No questions, Mr. Chairman.

Chairman **LaFalce**. Fine. Mr. Hull, you stated you weren't able to deduct anything for the health benefit that you provide.

Mr. **Hull**. Not on my schedule C, which is my business schedule.

Chairman **LaFalce**. I see.

Mr. **Hull**. I can deduct 25 percent of the premiums on my personal adjustment section of my tax return, but on my business section, none.

Chairman **LaFalce**. I just wanted to clarify that. I have been saying you could deduct 25 percent, so I was a little concerned.

Let me just ask a philosophical question. Everybody is saying the intent of section 89 is good, but then they come up with the wrong means of achieving that good goal. Let me challenge, just for the sake of argument, the question of whether the intent or the goal is all that good.

Should a small businessman have the right to discriminate amongst different employees as a means of giving rewards for people who are especially important to the organization, especially loyal, who have been there for 5 years as opposed to 6 months, who have never been sick or, if sick, come in, et cetera, et cetera?

There is a very good question, it seems to me, as to what is permissible and what is impermissible discrimination. We discriminate every day in life, and sometimes that discrimination is absolutely obnoxious and unconscionable. Discrimination on the basis of race would be foremost in that category, it would seem to me. Sometimes we discriminate, though, on other factors, and this is a part of life, it is a part of the human condition. Or is or isn't it a permissible type of discrimination for a businessman in providing benefits to employees?

Now we are not talking about 500,000 employees, we are talking about a small business where there are 10 employees. Would anyone care to come to grips with that? It is not a legal question, it is not technical, it was just in the back of my mind, and I thought I would throw it out.

Mr. **Hull**. I think in reality you find that small business does one of two things; they either offer the benefits to everyone or they don't offer them at all. I know in the case of the 400-odd small businesses that I do tax work for, I don't have one, that I can recall, that has a tiered structure on their benefit plan.

Chairman **LaFalce**. Suppose you have got 10 employees and 8 of them have been with you for 6 months to 1 year; there are 2 who have been with you from the day you started out, a 5-year period. Would it be illegal or discriminatory to say, "Well, I want to provide it to everybody who has been with me for a 5-year period, and if you get to be with me for a 5-year period you will be eligible also," or would that be an illegal type of discrimination?

Mr. **Raup**. I think we have the availability of doing that now under the law.

Chairman **LaFalce**. We would have it under section 89.

Mr. **Raup**. But section 89 doesn't necessarily help us get that done. We have said to our clients, "Gosh, you can still discriminate the old-fashioned way—cash." That is still there, I don't think anybody has taken that away, and it happens to raise a little extra revenue.

Inside the benefit programs, most employers who have a plan will offer it. The discrimination usually comes as to whether or not the employer wants to help some long-term employees pay for more of that coverage for them than others.

Again, there is the ability to do that through section 125 of the Code, and that is, the employer says, "If you work here, I pay for half the cost, you pay for half the cost." But, coincidentally, those that have been here longer he has given a raise to, and they have the opportunity to lower their salaries through section 125 and make that premium payment on a pretax basis. So it gets done, but the selection process is made by the employee. The bonusing, if you will, is done in cash, and I think that is primarily very fair.

The area I see a problem with, when you talk about a philosophical problem, is that, over the years primarily health insurance, which used to be a fringe benefit, something extra if you came to work for me as opposed to some other employer down the street, has now become a social right that we think all persons should have access to. We forget that some people just don't want it. There are some people who may be rich enough, they don't think they need to buy insurance. It has historically never been an employer problem, it is only created, that idea that it is an employer problem that these folks don't have coverage. We have focused in the last several years on the fact that the glass is an eighth empty, not seven-eighths full.

Chairman **LaFalce**. I don't want this to go by with anyone thinking that I agree with you even a little bit from that perspective. I think it is unconscionable that in American society we have almost 40 million Americans without health insurance, and I think that there has been almost no attention given, in comparison to the attention that should be given to that fact.

If I were to opt for my choice approach, it would be national health insurance ala Kennedy-Corman of a decade ago. But because of the budget deficits that have accumulated in the past decade, we have emasculated the capacity of Government to respond to societal problems, and now the Congress, faced with either avoiding the problems or dealing with the problems, is opting to try to deal with them but through the private sector and foisting on the private sector what ought to be in the first instance the responsibility of Government itself.

But the problem is that there are undue hardships for the small business community when you take that approach. There would be great undue hardships if we went to mandated health benefits for small employers. Now you exacerbate that tremendously, it seems to me, when you also impose a burden such as section 89.

However, for us to rail against the problems of section 89, to rail against the problems of mandated health benefits, and not to rail even more so against the problem of uninsured Americans is unacceptable, and I just want to get that on the table.

Mr. **Raup**. I agree with you that we need to concern ourselves on how we can provide coverage for those folks. My concern is that in the private sector, especially for small employers, there is a very fine line, hard to define, between when is it the responsibility of an employer to provide coverage for that person and when is there a social responsibility to help provide coverage for that person. It is, how far can the private sector go to take care of every one of those 37 million Americans, because they are not all working. There has to be some blend, a joint venture, if you will, for us to get there.

Chairman **LaFalce**. Thank you. I agree. Are there any other questions or comments?

Yes, Mr. Slaughter.

Mr. **Slaughter**. Mr. Chairman, I would just ask the question, if anyone has the information, aside from the repeal of section 89, was there a substantial extent of discrimination based on different plans for different employees, or is there now in existence such discrimination?

Mr. **Weizmann**. I think one of the interesting things I have learned from my Washington experience is that the plural of anecdote is data, so if I gave you two it is data, and if it is one it is not.

But the notion, I think, that there was preexisting discrimination in the system, the question needs to be refined. We have one employer member, for example, who approached section 89 the way it was originally intended, which was on a table basis where you could simply evaluate the plan using values created by the American Academy of Actuaries. That approach, at least right now, is languishing in the Treasury. But they approached it that way first, and then they approached it on a simple cost basis. They found that they passed easily under the table approach and they failed miserably under the cost approach. I am not sure this employer discriminates or not.

I don't know what discrimination is, but we are told in Washington it consists of two things. One is, you can discriminate as to eligibility; this is more in answer as well to Congressman LaFalce—you can discriminate first as to eligibility, and the second, which is the trickier aspect, is discriminating as to coverage.

I think as to the former I would argue that very little discrimination occurred. As to the latter, meaning actually employees electing coverage or not, I can't say if there is discrimination, simply because there are no realistic standards, section 89 included, which will get at why an employee declines coverage. Some employees simply decline coverage altogether because they would rather have cash. Some employees accept lesser coverage simply because they feel they don't need it and they would rather have cash. Section 89 doesn't discriminate between employers' or employees' motives or not; for purposes of the statute they either participate or they don't.

As to eligibility, I would argue there is very little discrimination as to eligibility. As to coverage, I think that the philosophical questions of what it is and how you get at it are best left for those who wear white robes and togas.

Chairman **LaFalce**. Yes, Ms. Calimafde.

Ms. **Calimafde**. If I could, I would just like to get back to your more philosophical question, and I think one of my answers to you would be, if I am a small business owner and I have 20 employees and I choose just to cover myself, is it fair that I get the deduction for that health insurance premium which, as it stood last year, I would be able to do?

Why I think the goals of section 89 are valid is that section 89 doesn't just say, "Well, you're the owner; therefore, you are highly compensated; therefore, we are going to tax you on the health insurance," it is just not black and white. What it does say is, "Well, if you bring a significant amount of your people into coverage under health insurance, then we won't tax the owners."

So what I think is valid about section 89 is, it is not all or nothing, it is working toward, "If you will cover your employees, then we will allow you to continue getting the deduction," and I think that is a valid concept. I think Mr. Weizmann's point about, is it enough of an incentive, is an interesting point. It may not be enough of an incentive the way it is drafted today. But I think rather than just saying, "We are going to tax you," where there is no incentive to cover additional people, I like the approach of, "If you do bring people along, then you will keep your deduction."

Chairman **LaFalce**. Would we eliminate this problem if we adopted a proposal similar to Treasury I, where we repeal section 89 and then tax the benefits appropriately defined as the premium payments in excess of a certain dollar amount of money?

Mr. **Weizmann**. At that point, do you need section 89? I think the answer is——

Chairman **LaFalce**. We would tax those benefits whether they discriminated or didn't discriminate.

Mr. **Weizmann**. That is right, just flat across the board. I think the answer to that is, of course, you would not need section 89. At that point, when you are taxing everybody, the penalty that is involved—and I put that in quotes—the penalty that is involved under section 89 disappears, not the discrimination.

Your question before in terms of, philosophically, should an employer be able to discriminate, I think, is an interesting philosophical point, but we have to bring it back to tax policy. Tax policy doesn't say, "You may not discriminate." What it says is that, "In order to have this tax subsidy we won't let you discriminate, and, if you do, you will be taxed on it."

So, as a consequence, many Government tax people say they don't care whether you discriminate. The only issue is whether you can earn the tax-free subsidy.

The answer to your question is, no, of course you wouldn't need section 89, but then again you would have to ask yourself whether the same amount of benefits would continue to be extended once the benefit is taxable.

Ms. **Calimafde**. I think the health care tax cap ran into a lot of problems, and some of the reasons were very valid reasons, one being that the cost of health care across the country varies dramatically. So if you set a cap, you can have people in one area of the country picking up a lot more tax than someone in another area of the country.

Chairman **LaFalce**. We have the same problem with congressional salaries. That is a fact of life. Unless you had regional salaries, regional approaches, that is just an inequity you are going to have to live with.

Ms. **Calimafde**. Right.

Chairman **LaFalce**. One of the things we have to learn is that we cannot address every conceivable inequity in the world.

Ms. **Calimafde**. Right; I think it is complicated, though, in the health care area because some small businesses may have very high rates of insurance, particularly high-risk companies or if you have a company that has a relatively older census than, say, your normal company.

So, in effect, the health care tax cap really discriminated against small businesses just because the health premiums charged were so much higher than what could be charged to, say, a much larger business.

Chairman **LaFalce**. The answer to that is, try to permit small businesses to participate in some type of a pooling arrangement where they could become part of insurance provided to a national trade association, or a Chamber of Commerce, or something along those lines, and to facilitate that as a means of reducing the costs, it would seem to me.

Mr. **Raup**. The other problem I see with that, Mr. Chairman, is that we have got two issues at hand. One is the need to raise revenue, and the other is the need to direct or set some guidelines up for a national health care policy, not necessarily a plan but where we want health care to be in this country. If we go with a tax cap, we raise another whole set of questions that we will start to hear about as to the effect and cause of whether small businesses could provide health coverage and how it is going to affect this group, that group, that part of the country.

I think we need to resolve two problems in two different formats: one, where do we want our health care policy to be? How do we want to encourage that to be done? Second, if we need to raise revenue, I think that should be a different question. Unfortunately, the history of benefits has been, well, we will encourage benefits by giving a tax break, so it has kind of led us to always deal with those at the same time.

Chairman **LaFalce**. I understand where you are coming from. Of course, your industry is subsidized in an unlimited fashion because there is no limit on the amount of the deduction, and, to the extent that there would be a limit on the deduction, we put a limit on the subsidy. But at some point in time I think Congress will have to come to grips with not the intellectual difficulties with that approach or the political difficulties with that approach primarily for groups such as yours, labor organizations, et cetera. It will be a very, very difficult thing to do politically, there is absolutely no question about it.

But as we put some type of limitation now on how much you can deduct for housing, put limitations on industrial development bonds, et cetera, one of the problems with the Tax Code, since it is an indirect expenditure, is, it is limitless, it is totally limitless, unless you put a cap even on the tax expenditure. Maybe that is my own personal feeling.

Mr. Hull.

Mr. **Hull**. One possible solution—and I have not thought it through to its finality—you may want to offer health benefits to, let's say, 80 percent of the people who are eligible or meet the entrance requirements with your 17.5 hours or your 6 months or you are under or over age 21, and in order for any premiums to be deductible by the employer, they would have to meet the 80 percent, or 75 percent, coverage requirement. So if they dropped below that coverage requirement, then none of the premium would be deductible for the employer. That would be a certain incentive. We were talking about how to offer incentives for deductibility or for nondeductibility but to have the employer give this benefit to the people—if you set a percentage, and if you fell under that percentage none of it would be deductible; over that, the entire amount would be deductible.

Chairman LAFALCE. This would be an opportunity.

Mr. HULL. Correct.

Chairman LAFALCE. Yes; as opposed to actually taking it. Then you wouldn't distinguish. I know you don't want different plans either, do you?

Mr. HULL. I think it could be virtually across the board. Nothing is that simple, but it is a concept.

Chairman LAFALCE. We are not here to rewrite it today; we just wanted to find out the difficulties that you do have. I think we have had adequate discussion on this, our second day of hearings, and the committee is indebted to you for your expertise and perspective on this issue. We will share our thoughts on this with the Ways and Means Committee, and we hope that the Ways and Means Committee will undertake a reevaluation of section 89. We will try to get as many Members of Congress to support that effort as possible as a means of persuading them. Thank you.

[Whereupon, at 11:30 a.m., the committee was adjourned, subject to the call of the Chair.]

EMPLOYEE BENEFIT RULES

TUESDAY, MARCH 21, 1989

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 9:38 a.m. in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LaFalce. The Small Business Committee will come to order. The Small Business Committee has scheduled today's hearing to continue its examination into the problems associated with section 89 of the Tax Code. This is our committee's third hearing on the Employee Benefit Rules that took affect January 1. Our previous hearings on January 24 and 25 explored the impact of the new nondiscrimination rules on small businesses and their affect on the expansion of health insurance coverage.

We learned at those hearings, based on testimony from business owners and employee benefit practitioners, that section 89 is likely to impede access to health benefits among the Nation's uninsured workers. Small businesses in particular will be discouraged from offering health insurance and may be prompted to reduce or even eliminate the benefits they now provide.

Section 89 requires all employers to collect detailed data on their employees, assign values to each of their benefit plans and conduct a series of numerical tests to determine if their health and life insurance plans are distributed fairly between their highly compensated employees and average workers.

We will hear more today about the extreme complexity of the law and the recently issued regulations and the costly administrative burden it imposes on employers. Specifically, we will focus on the impact of the law on the public sector, on the educational community and on nonprofit institutions. Witnesses representing each of those sectors will discuss the particular problems they face in attempting to comply with section 89.

We are also very fortunate to have with us today two former Treasury Department officials who will address some of the tax policy issues raised by section 89 and the economic effects of the law. The bill I introduced 2 months ago to repeal section 89 now has not the 252 cosponsors which we announced this morning, but 254 cosponsors. I believe that the law is so inherently defective, so contrary to sound tax policy that it should be repealed.

It should be repealed and then perhaps rewritten to establish a far more reasonable and simplified approach to achieve whatever policy goals one might have, especially if you are assuring fair distribution of employee benefits.

I would look forward to our witnesses' suggestions in that or any other regard.

I am going to ask each of the eight witnesses we have to come up to the table and if staff could provide appropriate chairs for all eight rather than just five of our witnesses—we will have to spread the mike around. I am doing that so we can hear from all of you rather than to have two separate panels and take 2 hours with the first panel and then the second panel will get short shrift. This means that our questions of you will be delayed. It also means that I would hope that you would summarize your prepared statements in approximately 5 minutes or so, but if you want to take a bit more than that, surely, no more than 10 minutes from any one witness, that would be permissible.

I will not read off the names of all our witnesses right now. I am pleased and proud of all of them, but I am especially pleased because I have a constituent here from western New York, the Hon. Donald Lubick, a former Assistant Secretary of the Treasury for Tax Policy in the Carter administration.

I also believe that Congressman McNulty has a witness here who is a constituent of his and perhaps he would like to introduce her at this time if she is here.

Mr. McNULTY. Mayor Karen Johnson will be here to deliver her testimony, but she is not here at this time.

Chairman LAFALCE. Why do we not wait. I would like to put in the opening statements of Congressman Joseph McDade and Congressman Silvio Conte at this point. Without objection, so ordered. Mr. Rhodes?

[Mr. McDade's and Mr. Conte's statements may be found in the appendix.]

Mr. RHODES. Excuse me, Mr. Chairman, I do not have an opening statement. I do want to introduce a constituent of mine who is a witness, Mr. Howard Rohan, vice president of Human Services of the Samaritan Health Services in Phoenix. Mr. Chairman, just briefly, let me commend you for continuing to focus attention on this issue. I think it is of tremendous importance. I am pleased to be a cosponsor of your bill and I trust that we will begin to get some attention in other quarters that might lead us to a resolution of this problem. Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you very much. With that, why do we not begin? I have an order typed out on a sheet of paper regarding the appearances of the witnesses and why do we not stick with that. As it turns out, the witness from my congressional district, Mr. Lubick will be first.

[Chairman LaFalce's statement may be found in the appendix.]

TESTIMONY OF DONALD C. LUBICK, FORMER ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, IN THE CARTER ADMINISTRATION

Mr. LUBICK. Thank you, Mr. Chairman and members of the committee. I would like briefly to summarize some of the considerations that are involved in dealing with this vexing section 89 issue.

Section 89 is really very different from most tax reform measures in that the volume of protest and the problems have largely centered on the compliance aspects of the law and much less so on the policy aspect. Never have I really seen such an outswelling of protest over the difficulty of complying with a section of the law. I have been involved with it over the past several years, not only in the formulation of the legislation, but lately to my great regret in trying to deal with the specific problems of specific employers in implementing these rules.

I would like to put it first, however, in its historical context. Before the 1986 act, health insurance premiums paid by an employer were excluded completely from the taxable income of an employee.

Similarly, when the employee filed a claim under the insurance, the reimbursement for his medical cost is also excluded from gross income. That gives an advantage to employees over those who have to furnish their own protection or do not have employers who provide it.

In addition, lately, we saw a great proliferation of so-called salary reduction cafeteria plans by which employees would elect to reduce their salaries, put them into a fund which would be used to reimburse them for those benefits that were not covered by their insurance. So, the result was that you had significant advantages for those who are covered by their employer plans over those who had to basically provide their own coverage and were, therefore, subject to a floor on deductible benefits which at the present time requires them to exceed 7.5 percent of adjusted gross income before they become deductible.

At the same time, the legislation also covers group term insurance which currently provides for an exclusion from gross income of premiums paid by the employee on $50,000 of coverage.

Now, the current cost of these tax expenditures provided by the tax subsidy for the exclusion is running very close to $50 billion a year. So, it is no wonder that when Treasury One, back in 1984, started to look at the tax system, they made some proposals in this area. Originally, they proposed that the subsidy provided by the tax system through the exclusion should be a limited one. It should apply to premiums paid by the employer up to $70 a month for an individual, up to $175 a month for family coverage. The excess should be taxable.

That attracted a lot of political heat, and was opposed by the insurance companies. It was opposed by employers. Perhaps most important, it was opposed by labor unions which felt it was an encroachment upon a fringe benefit which they regarded as practically sacred.

So that approach was rapidly abandoned in Treasury One, and in the revised Treasury Two proposals which came out, they made some proposals for taxing first dollar of coverage up to a limited amount, a proposal which went nowhere, but tucked in their proposal was a suggestion that there be a requirement that benefits be furnished on a nondiscriminatory basis.

The reasoning was and I believe it was thought that this had much more political appeal, this exclusion should not be allowed to be hogged by the highest paid employees. Everybody should get in on it and there should be assurance that it is provided on a broad basis.

So, when they went to try to implement that provision, they ran up against the need to try to make these rules work in situations where basically our experience was that deliberate discrimination was a very exceptional case. Therefore, we had to have a whole labyrinth of tests. As you have had previous hearings, I am sure you have heard about those tests. I have itemized some of the problem areas on page 5 of my statement. They cover percentage rules as to eligibility. We have a 50 percent rule and a 90/50 rule as to eligibility and coverage. You have 75 percent test for coverage and then you have an 80 percent alternative test for coverage. Legislation has set up a 90 percent alternative test, if you have different values, and the regulations have manufactured some new safe harbors that produce 80-66 percentages. The whole thing requires a quarterback to memorize all the signals. In addition, there is a general nondiscrimination test.

There is great difficulty in defining who are the groups that can be covered. You have immense problems of how you value benefits under different plans. You have problems of how you deal with the situation of two working spouses where one drops out because there is coverage from another employer. The end result is that we have produced a veritable monster as far as compliance is concerned.

The IRS, itself, in putting out its recent regulations which were supposed to be the key to explanation—and here is 150 pages of fine print that covers some of the problems, not by any stretch of the imagination all of the problems—the IRS estimates that the annual cost of learning about the law, doing the testing and making the elections runs from 1 to 40 hours per respondent.

Now, I have been trying to learn this for 2.5 years and if I ever go 3 or 4 days without working in the area, I find I have got to go back and almost start over again.

Chairman **LaFalce**. I think I should interject at this point. This is no ordinary practitioner. This is the former Assistant Secretary of the Treasury for Tax Policy who used to be involved in the drafting of tax laws and the drafting of regulations and is saying it did not take him 10 hours or 40 hours, it has taken him 2.5 years to try to understand.

Mr. **Lubick**. It has been a running target, Mr. Chairman.

Chairman **LaFalce**. OK.

Mr. **Lubick**. In addition, the IRS has estimated that the total cost of compliance for all respondents is 9 million hours. Now, I, giving the IRS the benefit of the doubt, would suggest that they have not understated this by more than 75 percent. [Laughter.]

But I took their number of 9 million hours and I multiplied it out by $30 an hour as the average cost—now, that is not my charge for doing this, but let us assume——

Chairman **LaFalce**. You charge at least a little bit more than $30 an hour.

Mr. LUBICK. It is not even our paralegal's cost. So, I gave them the break on that. If I multiply 9 million hours by $30 an hour, I come out with $270 million annually of compliance cost.

Then I went back and I looked at their forecast, what revenue they expected to pick up from this measure in 1986 and the costs of compliance that they estimate now are more than double what they predicted they would pick up. As I have indicated, I think their estimates of cost compliance are way low.

Chairman LAFALCE. Mr. Lubick, you said that 10-hour average is absurd, that you would estimate it is a 40-hour absolute minimum, not average.

Mr. LUBICK. For the simple plan.

Chairman LAFALCE. For the simple plan. So, that would really be 4 times 90, closer to 40 million hours, which at $30 an hour which is probably a third to a fifth of the average hourly cost that you are going to be charged, you are still at about $1 billion per year in compliance cost.

Mr. LUBICK. I would not give it a high rating on cost benefit efficiency.

Chairman LAFALCE. OK. What I am trying to get across is repealing section 89 gains money for the Treasury.

Mr. LUBICK. That is the health insurance. Then you have got, of course, the group term insurance. I am not quite sure what the significant problem in group term insurance was because you are talking about a maximum of $50,000 of coverage.

Then there is a little curve that has been thrown in here called 89(k), which is a general requirement that all plans have to meet certain requirements, be in writing, employees have to be notified, legally enforceable, a degree of permanence. These were thought to be relatively easy provisions.

The regulations came out and there are many curves in here. In fact, just before I came over I got a hurried call from one of my associates in my office: "Be sure you tell them about this problem." I am not going to burden you with this problem, but the question is what is legally enforceable. There is an example in there that if the employer has any discretion in determining who can go into the plan, on a post-retirement plan, it is not legally enforceable. You have all of these hookers in there that someone has to deal with. This was supposed to be a simple provision, the purpose of it was to protect the employees. We have got to make sure that their rights are protected.

So, what happens if the employer fouls up and does not comply? Then all of the benefits received by the employees, the reimbursements, the $10,000 that the employee has to pay for the cancer treatment, becomes taxable income because the employer fouled up. Now, that is a bizarre way to protect employees. So, that is where we are today.

Now, am I an advocate of repeal? No; this may surprise you, but I think the problem has to be addressed and cured. If you want to appeal——

Chairman LAFALCE. Your time has expired, Mr. Lubick. [Laughter.]

But you may summarize.

Mr. LUBICK. I will just use the time that you have taken away from me by interjections. I will take back my yielded time, Mr. Chairman.

Chairman LAFALCE. OK.

Mr. LUBICK. Basically, I think you have to solve the problem at the same time as you deal with the elimination of the monster. I would suggest a relatively simple approach.

First of all, I think one has to be politically realistic. It did not work in 1984 to propose taxing all benefits over a certain threshold, I think to a great extent because of rank and file pressure.

However, I do not see any reason why you could not have a rule that highly compensated employees are taxed on amounts over a reasonable threshold. I do not think that is a hardship. The threshold I suggested might be 110 percent of what the Federal Government pays as its contribution for its best health insurance plan or anything that is reasonable. But there is no particular reason to subsidize outlandish benefits for highly compensated employees.

Now, what about benefits up to that threshold? Let us say it is $300 a month. Again, I would set out a very simple test, simply require that to make sure it is not a plan simply for the high paid employees, make sure that it is offered to a reasonable broad base. Let us say if the highly compensated employees are not more than 20 percent of the offerees, that that should indicate that this plan has independent significance as a broad based offering by an employer.

In the case of very small employers where perhaps a greater share than that number are highly compensated employees, a general offering to all the employees over a minimum service could be worked out. That is simple enough.

As to the group term insurance, that whole benefit should not be involved in this. Again, as to highly compensated employees, simply lower the threshold of tax-free premiums to $25,000 of insurance and the requirement that it be pursuant to a group plan will insure that the low paid employees are included as well.

Finally, I think that it is most important that that 89(k) problem, putting that terrible sanction on employees for the employers' errors be taken care of. First of all, I have a real question as to whether 89(k) is necessary at all. There are ERISA requirements for a number of these plans. But if it is required, it should be much less stringent and the sanction should be on the errant employer and not on the employee. I think you can put all that together in a package with your repeal and your revision in a single bill that can go through simply and just deal with this problem.

I have heard many employers say they would much rather pay the tax, and I think that can be done in a modest way and avoid this complexity.

[Mr. Lubick's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very, very much, Mr. Lubick, for that excellent critique of section 89 and your suggestions for dealing with it.

We next will go to a former Under Secretary of the Treasury Department in the Reagan administration, now president of the Institute for Research on the Economics of Taxation, Dr. Norman Ture.

TESTIMONY OF NORMAN TURE, PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, FORMER UNDER SECRETARY OF THE TREASURY, REAGAN ADMINISTRATION

Dr. **Ture**. Thank you, Mr. Chairman.

Chairman **LaFalce**. It is a pleasure having you and Mr. Lubick at the table at the same time in basic agreement about the problems of section 89.

Mr. **Lubick**. Norman pointed out that is the first time he has ever been on my left.

Dr. **Ture**. But I am glad to be on your right, Mr. Chairman. [Laughter.]

I have to qualify my statement at the outset by pointing out that the views I will present at this time are my own and do not necessarily reflect those of our board of directors, staff, or its contributors.

I want to concentrate my remarks on the economic effects of section 89 and in doing so, I do not mean for a moment to minimize the kinds of problems that Mr. Lubick detailed so effectively. They are enormously difficult problems.

Section 89, as the committee knows, ostensibly seeks to minimize discrimination between highly paid and nonhighly paid employees with respect to fringe benefits and employment compensation.

At issue is whether section 89 effectively pursues a reasonable equity objective of tax policy. Also at issue is the likely effects of the implementation of section 89 with respect to the economic goals of tax policy.

In my judgment, section 89 is a long step away from rather than toward assuring greater fairness in compensation arrangements and their tax treatment. It identifies fairness as requiring all employees to have the same kind and amount of certain elements of compensation, primarily, health and life insurance. This requirement is imposed irrespective of employees' preferences about the components of their pay packages and irrespective of what other pay elements they must forego.

Section 89 mistakes sameness for fairness. Requiring sameness in major compensation elements can never be fair unless all employees are identically situated. In fact, the work force in most organizations is highly diverse in terms of work skills, family responsibilities, cultural background, economic circumstances, and so on. Fair and efficient compensation policies must reflect this diversity not only with regard to the total amount of compensation, but its components as well, in order best to conform each employee's pay package as closely as possible to his or her preference.

Employers have long been under pressure to diversify pay packages in a substantially free labor market. I believe that is what we have. Both the amount and form of compensation must be acceptable both to the employer and to the employee. If an employee deems a specific element of the pay package to be of little or no worth to him or her, the value of other pay elements must be sufficiently greater to meet the employee's price for providing his or her services to the employer. Unless you believe employees are always and invariably in employers' pockets, something that is entirely at odds with the facts of our labor markets, this must be the case.

Forcing on employees compensation elements they do not value is not only unfair but also exerts upward pressure on compensation costs. No employer can perfectly fine tune compensation arrangements. For this reason, pay packages will scarcely ever conform ideally with employees' preferences. Nevertheless, market forces impel virtually all employers to diversify compensation arrangements to some degree, weighing the administrative costs of diversified compensation packages against the savings in total compensation costs that that diversification provides.

Section 89 entirely overlooks and ignores these facts about the American labor market. This provision of the law also asserts that employees' preferences about how they get paid is not an important consideration in determining the appropriate tax treatment for fringe benefits.

Allegedly aimed at eliminating discrimination, section 89, in fact, discriminates grossly against employees at the lowest rungs of the job ladder. Most part-time employees are low paid. Most often various fringe benefits are not included in their pay packages for the obvious reason that these fringes could be provided to such employees only at an inordinate cost to them in foregone cash wages.

If section 89 were to operate to require inclusion of health and life insurance coverage in the compensation of these employees, their continued part-time employment would be jeopardized. Section 89 asks the employees least able to do so to bear its major brunt.

Section 89 is not only unfair, it will also exert upward pressure on employment costs throughout the economy. Employers will incur significant costs to determine whether the fringe benefit plans included in their employee compensation packages satisfy qualification and nondiscrimination tests, the sort of cost that Mr. Lubick so graphically detailed for us.

Employers will also incur significant payroll costs in adjusting compensation arrangements to meet the requirements of section 89. Total dollar cost of the new pay packages will necessarily exceed those of the old compensation arrangements if employees are to be as well compensated from their point of view as they were before.

Section 89 imposes an increase in the dollar cost of the work force on virtually every employer whose fringe benefit plans do not now conform with section 89 requirements.

Because nothing about these enforced changes in compensation automatically and necessarily increases employees' productivity, section 89 must lead to lower levels of employment as well as higher unit labor costs than otherwise would be the case.

Section 89 is the same thing as an excise tax imposed on the employment of labor service. It imposes a wedge between the cost to the employer of using a given amount of labor services and the rewards obtained by those supplying those services. Like any excise, it reduces not only the amount of labor services employed, but the efficiency with which these services are used as well.

Like any excise, section 89's effects will vary among industries, size of business, production methods, and other important variables in the business community. For many small businesses, these burdens may well be intolerable.

Labor-intensive businesses will incur substantially heavier costs than capital-intensive companies. Large businesses are likely to have access to sophisticated personnel management resources, but the data requirements they confront to undertake the section 89 tests and to comply with them are likely to impose costs that are out of all proportion to any discrimination in compensation that may be found.

At IRET, we are undertaking a survey aimed at determining what the experience through a very broad section of the business community will be in trying to apply section 89 tests and thereafter trying to conform with its requirements. I will be happy to provide the committee with a draft of the survey form which will be going out, I fervently hope, at the end of this week or early next week.

What we are aiming to do eventually, is to determine from the responses to this survey what the effect of the implementation of section 89 will be by different types of industries, companies differently organized by legal form of organization, and by size, in terms of their compensation cost, and the unit costs of labor.

In conclusion, in the aggregate by raising unit labor costs, section 89 will impair American businesses' competitive position in the world marketplace. It will make virtually all employees worse off than they otherwise would be. Taking into account the adjustments it will impel, it will generate very little additional tax revenue and, indeed, may very well involve substantial revenue losses.

It is misguided tax policy and it is bad economic policy. Its repeal would make for fairer and more efficient compensation arrangements throughout the economy. I, therefore, urge the committee to act as vigorously as they can to repeal section 89. Thank you.

[Dr. Ture's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much, Dr. Ture.

Congressman McNulty, I wonder if you would introduce our next witness?

Mr. MCNULTY. Thank you, Mr. Chairman. I am pleased to welcome to the deliberations of the committee a constituent, a friend, and an outstanding public servant, the mayor of the city of Schenectady, NY, the Hon. Karen Johnson. Before we ask her to testify, I wanted to point out to her that we have a number of friends on the panel, but one special friend, Karen, that you may not have met before, Congress Jim Olin of Virginia is the former supervisor of the town of Rotterdam, our neighbor. So, I wanted you to know that Jim is here as well, and we welcome you to the committee.

Mr. OLIN. I thank the gentleman for his comments. I lived in that area for 16 years and you can consider me to be sort of a substitute, Congressman, if you ever need one.

Mr. MCNULTY. Thanks a lot, Jim. I really appreciate that.

Chairman LAFALCE. Mayor Johnson, I did not think you were here when I tried to establish some rough guidelines for the testimony. We had asked all the witnesses to try to keep their verbal presentations to approximately 5 minutes or so. Everybody has exceeded that so far. [Laughter.]

TESTIMONY OF MAYOR KAREN JOHNSON, CITY OF SCHENECTADY, NEW YORK

Mayor JOHNSON. But you live in hope that I might. [Laughter.]

I am very pleased to have not only an honorary Congressman, but also my own here today. Mr. Chairman, I would just like to repeat for the record: My name is Karen Johnson. I am the mayor of Schenectady, NY, and it is a privilege to testify before this committee today on an issue which will have a direct and burdensome impact upon the Nation's municipalities; namely, the so-called section 89 nondiscrimination rules.

Before I begin, I would like to state for the record that while I am testifying in my capacity as chairperson of the U.S. Conference of Mayors Small Business Subcommittee, the conference has no official policy on section 89, and, thus, the views reflected here today are my own perceptions as mayor of the potential impact of such regulations on the city of Schenectady as well as other cities.

I would like to express my thoughts on behalf of the Government Finance Officers Association who contributed to the writing of this testimony.

Let me begin by first acknowledging your interest in this issue and the legislation, HR 634, which you have offered which would repeal section 89. Your keen awareness of the potential problems such complex regulations governing employee benefit plans will have with respect to State and local government is deeply appreciated.

As the overseer of the Regulatory Flexibility Act of 1980, the SBA is charged with analyzing Federal regulations to determine their impacts upon small governmental jurisdictions. Under the act, agencies must balance the burdens imposed by regulations against their benefits and propose alternatives to regulations which create economic disparities between different sized entities.

We believe that the burdens of this law far outweigh the benefits in the public sector. For example, there are thousands of small governments all over this country that are run by part-time mayors and councils where no employee meets the highly compensated salary levels. Yet, because the regulations require that even if there are no highly compensated employees that every entity has at least one officer and, therefore, is subject to section 89.

Spending funds on mandated compliance costs could mean one less police officer, teacher, or firefighter in these small communities.

As you well know, these cumbersome and costly regulations come at a time when local governments around the country are reeling from the various forms of Federal disinvestment in America's cities that has been occurring throughout the decade of the eighties. This disinvestment has taken the form of both substantial cutbacks in Federal funding for cities and restrictions placed on tax exempt municipal bonds.

We at the local government level have been forced to cope with both shrinking resources and a shrinking tax base while the problems of the cities continue to worsen. These costly regulations could not have come at a worse time for the Nation's cities as we try to deal with illiteracy, rampant drug abuse, a national housing crisis, and crumbling infrastructure, just to name a few of the problems facing cities today.

I understand that there is a crucial fiscal need for revenue at the Federal level today and section 89 could raise as much as $128 million in this fiscal year alone for the Federal Government. But from a cost benefit perspective, the cost of implementing the regulations will far exceed any realistic or reasonable benefit.

The Treasury Department conservatively estimates that compliance with the regulations will entail some 9 million hours of record keeping. Cost estimates that I have seen range from $250 million to $2 billion. One does not need a PhD in economics to know that this is neither prudent economic practice nor does it make fiscal sense.

The cost of compliance to my city could run as much as $37,500. While this may not seem to be a great deal of money to many larger jurisdictions, it certainly could be put to much better use in Schenectady.

What is most baffling to me, however, is that there is no apparent justification or clear evidence for the imposition of such regulations on State and local government. We certainly applaud the original intent of the legislation; namely, to discourage employers from offering health plans and other welfare benefits that disproportionately favor highly compensated employees either as to coverage or extent of benefits as stated in the Treasury Department final draft.

However, as is often the case, the proposed regulations represent overkill as far as perceived abuses are concerned. By not exempting the Nation's 87,000 State and government local units, local government units where as I have already mentioned, there is no clear evidence that abuse exists, we are effectively throwing the baby out with the bath water. It just does not make sense.

Typically, State and local governments offer the same benefit packages to all employees. In a recent Bureau of Labor Statistics publication entitled, "Employee Benefits in State and Local Governments 1987," it is reported that 94 percent of full-time State and local government workers participate in employer-sponsored health care plans. Not only are benefits equivalent among salary levels in the public sector, but the participation rates are extremely high.

The private sector has many more options available to it for complying with section 89. For instance, they can drop benefits entirely, switch to employee-paid benefits or gross up the salaries of the highly paid to compensate them for any additional tax that must be paid on excess benefits.

Public employers have fewer options. Because benefits are generally viewed as a contractual right of employment in the public sector, diminishment or elimination is not possible. Moreover, budget constraints make the grossing up option fiscally out of reach. Thus, in an ironic twist, in the private sector where the majority of discrimination occurs, employers are in a better position to continue to favor highly compensated employees.

To say that an exhaustive review or reading of the regulations would make them less complex or confusing would be an understatement of the greatest magnitude. In fact, they are so complex that the Internal Revenue Service has had a difficult time figuring them out.

Under the act, which was signed into law in October 1986, the effective date of section 89 was years beginning the later of December 31, 1987 or the earlier of December 31, 1988 or 3 months following the issuance of Treasury regulations.

As 1988 waned on into the fall, it became abundantly clear that section 89 would go into effect with no regulations, no proposed regulations, no rulings, no advice, no notices or even unofficial guidance from the IRS. As general panic became prevalent even among those who had thorough familiarity with the code section, it was hoped that Congress through the Technical Corrections and Miscellaneous Revenue Act would at least delay the effective date of section 89 until the IRS could figure out implementation standards and issue regulations.

Instead, the tax legislation passed last year mandated that the IRS issue regulations by November 15, 1988. As November 15 came and passed, nothing happened.

Beginning early in 1989, reliable publications continually quoted unofficial sources from the Treasury Department as saying that regulations would be issued within a few weeks.

Finally, on March 2, 1989, after 2.5 years since the signing of the act, the IRS issued its 83-page notice of proposed rulemaking on some—and I repeat—some of the requirements of section 89.

The regulations in their present form do not address such key issues as group life insurance and who must and must not be counted in discrimination testing.

What they do address will undoubtedly draw criticism from employee benefits experts.

There must be an easier way. Where there are abuses, I wholeheartedly endorse correcting them. Where there are loopholes, let us close them. However, this is like doing delicate surgery with a butcher knife.

I support your efforts to bring sanity to this issue and can only reiterate that it makes little sense to further hamstring local governments with costly administrative mandates to correct a problem which does not exist. Barring reexamination or outright repeal, State and local governments should be exempted from this legislation.

I sincerely appreciate the opportunity to testify before this committee today. I wish you luck in this issue and offer my assistance, the assistance of the U.S. Conference of Mayors and the assistance of the Government Finance Officers Association in seeking a remedy that will remove further unwarranted financial and administrative burdens on the Nation's municipalities. Thank you very much.

[Mayor Johnson's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much, Mayor Johnson.

Our next witness will be Mr. Terry Wood, the president of the city council of Jacksonville-Duval County, FL, and also the chairman of the Pension Employee Benefits Committee of the National Association of Counties. Mr. Wood.

TESTIMONY OF TERRY WOOD, PRESIDENT, CITY COUNCIL, JACKSONVILLE-DUVAL COUNTY, FL, AND CHAIRMAN, THE PENSION EMPLOYEE BENEFITS SUBCOMMITTEE OF THE NATIONAL ASSOCIATION OF COUNTIES

Mr. WOOD. Thank you, Mr. Chairman, for the opportunity to testify on behalf of the National Association of Counties. I am Terry Wood, president of the Jacksonville-Duval County Council in Florida and chairman of the NACO Pension Employee Benefits Subcommittee. Before I assess the impact of section 89 on county governments, let me first say that we highly commend you for holding these hearings and calling attention to the need to correct an onerous tax rule that adversely affects the taxpayer and discourages the provision of employee benefits.

Section 89 was adopted in the 1986 Tax Reform Act to discourage discrimination that favors highly compensated employees in employer-provided tax-exempt benefit plans. Unlike our system of justice, which assumes innocence until proven guilty, section 89 assumes that all employers are guilty of discrimination until proven innocent.

To determine if discrimination exists, each benefit plan offered by an employer must pass a series of highly complicated tests. If discrimination is found in any plan, employers and their highly paid employees can be penalized with higher taxes.

Mr. Chairman, we understand that many in Congress have been convinced that section 89 will expand medical insurance to uninsured workers. Recent reports indicate that 25 million working people have no medical insurance. This is a deplorable fact that demands immediate attention in finding a practical and timely solution.

The intent of section 89 is to expand benefits to uninsured workers. However, we are not convinced it will do so. Instead of encouraging expanded coverage, we believe the complicated testing requirements will cost taxpayers more, unfairly penalize employees and cause some employers in the private sector to drop insurance coverage for some or all of their employees.

To assess the impact of section 89 on counties, let me begin by providing a few basic facts about county governments. There are 3,106 counties across the Nation that vary in size, demographics, and wealth. About three-fourths of all counties have a population of less than 50,000. Our smallest county is Loving County, TX, which has a population of 87. Our largest is Los Angeles County, CA, which has a population of over 8 million.

If we use the 1986 census data on the average annual per capita income as a measure of wealth, counties would vary from a low of $3,374 in Star County, TX, to a high of $23,161 in Fairfax County, VA.

The major source of revenue for most counties is the property tax and in most cases we are limited by State law on the amount that may be assessed on an annual basis. Consequently, there is not a lot of room for flexibility in our budgets. Because of the limitation on our ability to raise taxes and a 47 percent reduction in Federal assistance to State and local governments over the last 7 years, many counties have been at their maximum taxing capacity for several years.

Counties are not merely employers, Mr. Chairman. We provide a full range of vital public services to our residents including health care, education, law enforcement, fire fighting, courts, maintenance of roads and bridges, and nursing homes. As employers, we offer our employees fair wages and reasonable benefits. In many cases wages and benefits are negotiated at the bargaining table. Generally speaking, we offer the same benefits to all of our employees.

In at least 31 States, counties are required by law to pay for indigent health care services. We are already providing health care services to many uninsured workers that section 89 was intended to assist. While we cannot give the specific breakout of how much funds are expended for uninsured workers, we are convinced that a significant amount is expended on these workers.

We are in the process of conducting a nationwide survey to determine the amount of funds counties expend on health care services for indigent workers as compared to other indigents. We would be happy to share the results of this with the committee when the survey is completed.

As service providers, we spend a significant amount of revenues each year to provide health care to the uninsured. Health care for the uninsured is one of the highest, if not the highest, costs for county governments.

The 1986 census data shows that counties spent $14.9 billion on health care services. It also identifies $7.2 billion in uncompensated health care costs for hospital services.

While these costs represent the total loss for public and private hospitals, it is safe to assume that the majority of these costs were borne by county hospitals since most private hospitals refer their uninsured patients to us.

Let me assure you that no one is more interested in resolving the uninsured indigent problem than county governments. We feel very strongly that the provision of health care services to the uninsured must be accomplished through shared responsibility between the county, State, and Federal Government and the private sector.

Counties spend billions of dollars annually on the uninsured. We fear that section 89 will cause States and localities to divert funds from badly needed public services to pay expensive consulting and legal fees merely to figure out how to pass a series of complicated tests.

Local governments have historically offered simple uniform benefit programs to both their elected and civil service employees. In most cases, they do not remotely resemble the plans offered by their private sector counterparts.

The Bureau of Labor Statistics found in a 1987 survey that 94 percent of full-time employees in State and local governments had medical insurance coverage and 85 percent had life insurance coverage. The survey also shows that in a majority of cases, public employers pay the full cost for individual employee coverage. In 27 percent of the cases, we paid the full cost for family coverage, and in an additional 66 percent of the cases, we paid a portion of the family coverage.

While the full impact of section 89 on the public sector will not be known for some time, we believe the cost of compliance will be in the hundreds of millions. In my area alone, we are estimating that the cost of compliance for the first year will exceed $250,000 for staff, consultants, and computer equipment and continuous administration. That is for Duval County and Jacksonville where I am from.

Instead of spending these funds on consultants and lawyers, I am sure you will agree, Mr. Chairman, it would make much more sense to use these funds to provide vital public services, including health services to the uninsured.

Moreover, the cost of compliance in the public sector could mean a substantial increase in costs to the taxpayer. Unlike the private sector, the cost of personnel and other expenses related to public sector compliance will be directly borne by the taxpayer.

Annual compliance reviews, for even the smaller counties, have been estimated in the range of $5,000 for the smaller counties to $¼ million and above for larger counties such as Duval. Using these figures to develop a rough estimate of the total cost of compliance with section 89 in the public sector, we believe we will be required to expend $435 million.

In summary, Mr. Chairman, State and local governments should be exempt from section 89. There is no evidence of discrimination in public sector benefit plans. Furthermore, we are already spending a significant portion of our revenues to provide health care to uninsured indigents.

It is extremely unfair to saddle our taxpayers with these additional costs under the guise of expanding benefits to the uninsured, particularly when almost all of the additional costs in the public sector will be related to consultants and lawyer fees.

Public sector employers are exempt from the Employee Retirement Income Security Act, and we are treated differently from the private sector in the Fair Labor Standards Act because we do not discriminate in providing benefits to our employees. We are subject to the same public scrutiny as State and local officials and we are not in business to make a profit, but to serve people.

For these reasons, we urge you to exempt States and localities from section 89. Thank you, Mr. Chairman, for the opportunity to testify. I would be happy to answer any questions at the appropriate time.

[Mr. Wood's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much, Mr. Wood. I, too, am very anxious to get to the question period, but we have so many excellent witnesses, we will have to hear from them all before we do that.

Mr. WOOD. Surely.

Chairman LAFALCE. We have heard from former Treasury officials. We have now heard from the mayors of America and from the counties of America. Let us now hear from the colleges and universities of America.

Dr. Frederick Ford, executive vice president and treasurer of Purdue University in Indiana speaks today on behalf of the American Council on Education and the National Association of College and University Business Officers. Dr. Ford.

TESTIMONY OF FREDERICK FORD, EXECUTIVE VICE PRESIDENT AND TREASURER, PURDUE UNIVERSITY AND ON BEHALF OF THE AMERICAN COUNCIL ON EDUCATION AND THE NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS

Mr. **Ford**. Thank you very much for the opportunity to appear today and to speak on behalf of the many colleges and universities that are struggling with section 89.

I have prepared a paper and submitted it for the record, so, I will not read that to you, but let me highlight some of the key problems and concerns that we have.

Chairman **LaFalce**. Yes; I want to say that it is an excellent paper and I hope you will highlight a good many of the concerns because I really thought your testimony was very well prepared.

Mr. **Ford**. Thank you very much.

Our largest financial concern was taken care of in the 1988 Technical Corrections Act. That is: Eliminating part-time student employees. We thank you all very much for that. However, we are aware of the vulnerability that we have in that the exclusion took place by fact that student employees are not now covered by Social Security and if Congress ever changes their mind on that particular point, we are going to get a double whammy.

Colleges and universities' pension and fringe benefit plans have traditionally not been a discrimination problem. The basic nature of colleges and universities and the way they are managed essentially precludes this from happening. So, section 89 is not really needed from our standpoint, yet, many schools because of the technical aspects of the way these tests are performed may not be able to pass the requisite tests.

Section 89, as others have testified, and the some 200 pages of proposed regulations are very complex. We were amazed to learn that the paperwork reduction people were estimating that employers would spend an average of 10 hours learning and applying the tests. I can speak from experience at Purdue University, they are mistaken by hundreds of hours. Colleges and universities are not staffed to handle something like section 89. Our only way to deal with it is to hire expensive consultants and this, of course, diverts resources, diverts dollars, does not teach one student, does not do any research.

At Purdue University, so far, we have spent slightly over $100,000 just studying, collecting data, and analyzing that data—and we have not even gotten to the final regulations, yet.

Colleges and universities lately are being criticized for large fee increases, but it is things like section 89 that are behind these. As our costs go up, we have to have additional revenues to cover those costs. Student fees are the most likely source of revenue that we have available to us.

Section 89 is particularly troublesome for those of us who have cafeteria-type programs, which are designed for faculty and staff to allow them to customize their packages to fit their particular needs. Because the way section 89 tests are constructed, this may cause the institution to fail the tests and may cause some colleges and universities to drop these kinds of programs. Others who are considering them, will be discouraged.

We also were amazed at the number of pieces of data and information you have to collect about each individual faculty and staff member. The number is over 50. While we thought Purdue University had a pretty good personnel record system, we spent 2 months collecting additional data in order to be able to run the tests to see whether or not our programs would qualify.

Chairman LAFALCE. Dr. Ford, when you spoke of $100,000, you were talking about outside costs, I would assume.

Mr. FORD. Right.

Chairman LAFALCE. Not your internal staff.

Mr. FORD. Not inside staff.

Chairman LAFALCE. Not the fact that it may have taken 50 percent of your time and——

Mr. FORD. This was in consulting fees, in hiring them to run computer analysis and so forth.

Chairman LAFALCE. Your internal cost could have been 10 times higher than that.

Mr. FORD. That is right.

Chairman LAFALCE. Or a 100 times higher than that.

Mr. FORD. It could have been substantially more than the $100,000, yes, in terms of chewed-up staff time.

Chairman LAFALCE. Go ahead.

Mr. FORD. Section 89 is very restrictive in its nature. It imposes a very rigid viewpoint as to which particular benefit designs may have favorable tax treatment which means that it limits our ability in the future to be creative and to provide fringe benefits that will serve particular needs of our people.

Colleges and universities, as I have indicated before, are very thinly staffed, particulary in the administrative and the support areas. We traditionally try to put as much of our resources into the teaching and research functions as we possibly can. So, when we are hit with a task like section 89, we cannot absorb it with our existing staff. We will have to hire additional staff. That runs our costs up and we are back to increasing student fees.

Finally, based on the analysis that we have done at Purdue to date, we think that Purdue can pass the test, but we have not had a chance to study and analyze the data under the newly published proposed rules.

However, if we pass under the new rules, then we will have spent a lot of money just proving what we knew all along, that is that our programs were not discriminatory. If we cannot pass, then we will have to change our fringe benefit programs to meet the new criteria. Certainly, you can be assured that the cost of changing those programs to meet those criteria will be substantial.

Chairman LAFALCE. If you pass today, you do not know that you will pass 6 months or 1 year from now, do you?

Mr. FORD. That is right. They are very dynamic and they change. Just because you pass today, the next time you test, because people may have changed their enrollment in different benefits, especially when you have a cafeteria program, there are no guarantees that you will pass in the future even though the plans remained unchanged.

Chairman LAFALCE. Sure; it has nothing to do with what you offer. It has to do with what they decide to take.

Mr. FORD. That is right. Let me make one statement in conclusion.

Chairman LAFALCE. Surely.

Mr. FORD. Purdue and the many other colleges and universities would gladly participate in efforts to further the policy goal behind section 89. However, the basic structure is such that it is very burdensome. We doubt section 89's ability, really, to further the goals in their current form and we urge the committee to repeal the existing regulations and start over and develop a more simplified form of rules. We need rules that will give us flexibility. Flexibility to devise programs that will best serve faculty and staff and rules that will allow us to know that the plans are nondiscriminatory because of their design. Back to that dynamic issue we just talked about a minute ago. In this way, we can hold costs down and we can minimize the impact on student fees.

Thank you very much for listening and I will be happy to answer questions when that opportunity presents itself.

[Mr. Ford's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much for presenting the perspectives of the colleges and universities of America.

Now, a good many individuals think that we are heeding the counsel and advice primarily of the profit-oriented segment of America, whether large business or small business, but this law is applicable to all employers and now we will hear from Mr. Howard Rohan, a spokesman for the not for profit organizations of America, particularly those involved in the health care industry.

Mr. Rohan.

TESTIMONY OF HOWARD ROHAN, VICE PRESIDENT FOR HUMAN RESOURCES, SAMARITAN HEALTH SYSTEMS ON BEHALF OF THE AMERICAN HEALTHCARE ASSOCIATION

Mr. ROHAN. Thank you, Mr. Chairman. Before I left Phoenix, one of my staff gave me a message for those back here in Washington. I said, "What's the message?" and he said, "Well, you are going to talk on section 89," and I said, "Not as an expert, but as a witness," he said, "Well, tell them, whoever them are, that 89 has all the product signs of a consultant married to a lawyer." [Laughter.]

That is how people tend to look at how this product was developed. I am representing the American Healthcare Association which is a shareholder organization of large not-for-profit hospital systems in the country, but come from Samaritan Health Service in Phoenix, AZ. We are the largest health care employer in the State and the fifth largest secular nonprofit hospital system in the country with 9,500 employees. So, my testimony here today will cover the nonprofit health sector and some problems that we have in implementation.

I am pleased to have this opportunity to come before you and I hope that some of my comments will be helpful. I will not read my statement, you have it and I will just touch highlights on it if I may.

In a nutshell, we think the headlines are that section 89 is not going to work. Its goal to extend health care and at the same time produce revenues through tax penalties to employees and employers will mostly likely produce different results. It probably will not extend health care to those that do not have it. It probably will not produce the revenues that it had hoped to produce. But, instead, it may force organizations, especially small nonprofit organizations, to discontinue health care benefits because the regulation is overwhelming, onerous, and too complicated to deal with. That does not serve the purpose of the original intention of the regulation.

In the health care arena, in the nonprofit health care arena, there has been a phenomenon in the last 2 or 3 years that has been taking place and that is the result of DRG's and Medicare reimbursement programs, fixed price contracts, managed health care contracts through HMO's, which have rapidly diminished the health care system's net income ability. So, the nonprofit health care industry, which has as its basic mission a community interest, operating with high quality health care at affordable costs, has been faced with a balanced concern between operating these hospitals at lower expenses and still not affecting the quality of care that each of us expects when we go to the hospital.

This has required managers in the health care system to really have to manage in a for-profit mentality which, by the way, is not all that bad. But we still are a nonprofit group of organizations.

Now, along comes section 89, and across this country in the last year or so, there have been several hospital closings, there have been quite a few downsizing of forces, all in an attempt to get the expenses in line along with the financial environment that we are all operating in and we are not resisting that. We are trying to solve it.

But section 89 comes into the hospital arena and it brings with it such a horrendous set of regulations and imposes so many costs on us that we just do not see how we can operate with it.

For example, hospitals operate 365 days of the year. Unlike general industry, they do not close on Saturdays or Sundays but they operate around the clock.

Because they do, they have a variety of work schedules that would stagger some people's imaginations. We have in many hospitals eight or nine different classes of employees and these employees work different kinds of schedules than are normally thought about in a normal workforce. These employees choose these schedules, and they are known, many of them, as a part time or supplemental workforce. They work as low as 8 hours a week in many cases or as much as 48 hours plus in a week. But they are still called a part time or supplemental workforce.

Now, section 89 would impose on us a whole series of nondiscrimination tests on these employees, and many of these employees are not, in fact most of them are not the primary wage earner of a family.

We have a problem here to pass discrimination tests with this kind of a workforce. The problem is really big.

For example, at Samaritan, among our 9,500 employees, 2,200 of these are in this part time workforce. They choose not to take benefits.

We offer them benefits, they elect not to take them. In many cases they do not need them. Yet we would have to include these people in our testing requirements. If we do not pass the testing requirements because of the inclusion of this workforce, we have ourselves a real problem.

There is also a workforce that overlays itself on the health care system called leased employees, or registry-type employees.

These employees are skilled professionals who prefer to work out of registries because they choose the work hours they can work from the registries and they like the pay they get from the registries. The pay many times is 60 to 70 percent more per hour than they would get from a hospital, but of course with it comes no benefits. But they choose that way of life.

Many of these employees are full time employed hospital nurses and physical therapists who take this registry work on the weekends or at nighttime to make additional income. Yet we must count these employees under section 89 on some basis and we do not know whether to test them, not to test them; we do not know how to track them. So that becomes a problem.

Samaritan is a large multihospital system, and we have several lines of businesses. The whole question of what is a line of business in a hospital becomes very difficult to determine under section 89.

We do a lot of joint ventures in an effort to disperse our businesses and to be more diversified, and yet we have one umbrella benefit plan for the welfare of all the employees.

Under section 89 we have to separate this one benefit plan into probably several different plans. Our early estimate is that our basic 6 plans would probably be carved up into 150 plans.

I will assure you we have neither the computer staff, the human resource staff, nor the income to handle that.

So far in our estimates for 1989 we feel that Samaritan as a major hospital system will probably expend $100,000 on the testing and consulting activities not including staff time and whatever else is ahead of us down the road.

So we feel that we have a real problem in the nonprofit arena and I want to come back and say that the whole thrust of section 89 just negatively impacts the primary mission of our nonprofit hospitals, which is to provide quality care at reasonable prices.

In this severe financial environment we are in, the challenges to management are severe.

With respect to recommended relief, we make an appeal to the committee to get the messages to the tax writers regarding this serious problem, report the analyses today here of eight of us to the tax writers in Congress, tell them it has laid a tremendous financial burden on our industry and rest assured it will probably bring unanticipated problems not envisioned by the drafters of this bill with respect to the part time and supplemental workforce who we predict will probably go without benefits in order to comply with this law.

We think it is incumbent upon those of you in position to influence change and we think short of repealing section 89 it needs to be deferred and redrafted.

I might point out in conclusion that most health care welfare benefit plans and group life plans are nondiscriminatory, and have been. Many of them are modest in nature. But we are going to spend a lot of money to prove that we are in compliance, and that is the big problem. Thank you.

[Mr. Rohan's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much. Now let me call on someone who must be responsible for the administration of this, because his group represents the personnel administrators.

Mr. Gary Kushner, representing the American Society of Personnel Administration. Mr. Kushner.

TESTIMONY OF GARY B. KUSHNER, CHAIRMAN, COMPENSATION AND BENEFITS COMMITTEE, AMERICAN SOCIETY FOR PERSONNEL ADMINISTRATION

Mr. Kushner. Thank you, Mr. Chairman. My name is Gary Kushner. I am president of Kushner and Co., Inc., a Kalamazoo, MI, based national employee benefits consulting and administration firm.

I just ought to say for the record that we should not blame everything on the consultants. No consultant I know of was involved in writing section 89. [Laughter]

Chairman LaFalce. You are talking about consultants as of the time. They may be consultants now who wrote it then.

Mr. Kushner. As a matter of fact, they are now.

Chairman LaFalce. Is that correct?

Mr. Kushner. But that should not impugn the industry as a whole. [Laughter]

Mr. Kushner. I am here, however, in my role as chairman of the Compensation and Benefits Committee for the 40,000-member American Society for Personnel Administration [ASPA]

ASPA represents individuals employed by companies which collectively employ more than 41 million people and includes managers from a cross section of American business, from large corporations to smaller family operations as well as governmental entities and not-for-profit firms.

Human resource managers are in a unique position to provide practical guidance on employee benefit issues, and we encourage employers to offer competitive and diverse benefit packages. Therefore, I appreciate the opportunity to appear before this committee on the subject of section 89 and I applaud your efforts to repeal this onerous law.

I would like to start off by emphasizing the fact that ASPA supports the congressional intent to encourage employers to expand the number of employees receiving benefits.

However, as one who deals with employee benefit plans every day, I would like to assure you that, in trying to accomplish this goal, Congress has created a law that is so complex and imposes such substantial administrative burdens on employers that it is a very effective impediment to employers who wish to expand the diversity and scope of their employee benefit coverage.

The much-anticipated section 89 regulations which were so difficult to draft that they were issued almost 4 months behind schedule by the IRS provide little relief from and even less clarification of a law which took effect January 1 of this year.

Section 89 is driving plan sponsors to either simplify their plans by reducing health benefit options and cutting back on subsidized family health coverage, or simply eliminating health benefits for employees.

For this reason, we urge Congress to relieve employers of this unrealistic burden.

As we know, section 89's regulations were finally published on March 7 in the Federal Register. However, I do not believe that many employers are any closer to a clear understanding of exactly what the new law entails.

While the regulations do contain some transitional relief, they do little to reduce the law's burdensome data collection and testing requirements.

In a few cases, the IRS uses the transition rules contained in the regulations to actually make the testing requirements more complicated, and, in at least one case, even seems to exceed its statutory authority.

For example, the regulations appear to require the 50 percent eligibility test as a prerequisite to using the 80 percent alternative coverage test, a provision clearly not included in the original statute nor its legislative history.

While the IRS provided some relief——

Chairman LAFALCE. That may not be the only instance when they went beyond their scope of authority here.

Mr. KUSHNER. Surely in this context, that was the one that came to mind first.

While the IRS did provide some relief to a few employers of over 5,000 employees, it gave no such assistance to the small business community which, because it lacks the necessary resources, will have a more difficult time with compliance.

It is interesting to note that this particular relief provision might conveniently apply to the Federal Government thereby exempting it from testing.

Additionally, the regulations do not include much-needed guidance on group term life insurance plans, excludable employees, leased employees, separate lines of business and multiemployer plans.

Chairman LAFALCE. I just want to point out how important each of those are.

If you have a corporation with a number of subsidiaries, different plants, different operations, et cetera, what is a separate line of business? If you have no idea, how do you even begin to start complying?

Mr. KUSHNER. An excellent point. It is an item that we sorely needed.

Chairman LAFALCE. I am editorializing, yes.

Mr. KUSHNER. But please feel free. To comply with section 89's regulations, the employer is even required to obtain sworn affidavits from employees, submitted under penalties of perjury according to the regulations. The employee relations impact of this provision is deplorable.

To avoid additional taxes, the employer must prove that each separate plan option can pass a series of statistical tests. Unbelievably, a plan can be deemed discriminatory if a proportion of lower paid employees choose not to participate, even if all employees are offered equal access to the plan.

This has a tremendous impact on smaller employers since any individual employee may represent a large percentage of such employer's workforce.

Chairman LAFALCE. It is not equality of opportunity, it is equality of result, the perfect egalitarian society, whether you want it or not.

Mr. KUSHNER. OK. [Laughter]

What does all of this mean to employers?

One small to medium-sized ASPA member has told us that his company will face first-year compliance costs of $3,000 for in-house staff time and $20,000–$25,000 for outside consultant fees to assist in actuarial valuation and statistical evaluation of its plans. It will face second year costs even greater.

What does this mean to that employer's employees? In this case, section 89 is forcing the company to delay perhaps indefinitely the implementation of a planned employee flexible benefit plan.

An ASPA member of a smaller company was not able to find any outside consultant assistance on section 89 for less than $7,500. Yet another's company will be forced to scrap its diversified benefits structure and return to its pre-1985 single health plan option for all its employees.

Speaking as a consultant, I perceive section 89 as a regulatory mine field. There are so many potential pitfalls and penalties contained in the complicated regulations for an employer who offers anything other than the most basic health benefits to its employees that some consultants are advising their clients, especially small business owners, to reduce or terminate health care coverage to their employees.

It is simply not worth the risk, and it is the easiest and least expensive section 89 compliance method.

To make matters worse, section 89 is entering the picture at a time when health care costs are rapidly escalating, with costs to employers increasing 30, 40, or even 50 percent or more per year.

Many employers are angry that they will have to spend considerable sums of money merely to prove what they knew all along—that their plans are not discriminatory. Others are angry that they are being penalized for offering extensive diversified benefit packages which best meet their employees' needs.

Significantly, these flexible benefit plans already meet their own series of nondiscrimination tests relative to eligibility and benefit coverage.

The end result of section 89 is the exact opposite of congressional intent. Employers will reduce or eliminate health care coverage to employees.

In the meantime, Mr. Chairman, I present the following ideas only as constructive suggestions for how section 89 could have been made less burdensome to employers, not as alternatives to your repeal efforts:

One, Congress should have excluded collectively bargained plans from testing altogether;

Two, passage of section 125 cafeteria plan tests could have been made a safe harbor for section 89 purposes, instead of requiring separate tests for every coverage option available under those types of plans;

Three, employers could have been allowed to consider employee-only and family coverage options under the same benefit structure as the same plan and Congress could have eliminated the sworn statement requirement.

Congress could also have designated a higher threshold for part-time workers. It is an unfortunate fact of life that setting a low parttime threshold does not protect the part time worker, it merely discourages the employer from maintaining or creating positions which exceed the minimum hours per week definition.

Finally, Congress should not allow exemptions for the Federal Government, including the legislative branch. If Congress and the Federal Government itself have to do this testing even once, they will get a flavor for what other employers are up against.

I commend Congress for trying to encourage employers to broaden benefit coverage to all their employees. But clearly, section 89 has failed to achieve that goal and instead will have a deleterious effect on employee benefits.

I thank you for the opportunity to testify here today and would be happy to answer any questions the committee might have.

[Mr. Kushner's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very, very much for your excellent testimony. I have also often thought that if we had to apply it to our own staff, for example, where I think we are authorized 18 personal employees, how would we handle it?

We might have to have just all single people because if we had married people and their spouses had a plan and their spouse's plan was better than the Federal plan, and it probably would be if they didn't work for the Federal Government, because the Federal plan is not that good, they would not take it and if they did not take it that would determine whether or not I was discriminating and therefore I might be discriminating.

So let me just discriminate in the first instance by hiring only single people.

Then how would I handle the fact that I only have 4 parking spots for my employees? Could I offer it only to 4 people if I hire 10 people in my Washington office or would that be discriminatory, et cetera, et cetera.

Mr. KUSHNER. I would like to point out, Mr. Chairman, that under the qualification rule——

Chairman LAFALCE. I would have to eliminate parking for all my employees.

Mr. KUSHNER [continuing]. If you pay for parking you are required to have a written plan document on that benefit that you provide.

Chairman LAFALCE. OK. We better go to our next witness and our last witness, and this is someone who is involved in the insurance business. I think that will present an interesting perspective too. We had at least an equal number who wanted to testify today, too, but we thought a panel with eight was adequate.

So our last witness will be Mr. Ronald Danilson, the associate director for group underwriting of the Principal Financial Group.

Mr. Danilson.

TESTIMONY OF RONALD DANILSON, ASSOCIATE DIRECTOR-GROUP UNDERWRITING, THE PRINCIPAL FINANCIAL GROUP

Mr. DANILSON. Thank you very much, Mr. Chairman. I am Ron Danilson, associate director, group underwriting with responsibility for product development and legislative compliance activities for the Principal Financial Group headquartered in Des Moines, IA.

The Principal is a major underwriter of employer-sponsored life and health insurance and provides coverage for over 60,000 employer groups located throughout the United States.

Of this number, some 50,000 are employers with 10 or fewer covered employees whose plans include approximately 360,000 employees and their dependents.

I appreciate your invitation to participate in this hearing and to have the opportunity to share with you some of our concerns and our experiences in assisting our small employer customers with section 89.

I will limit my oral statement to only those areas of major concern for our small employer customers. I would ask, Mr. Chairman, that you refer to the written statement the Principal submitted for your hearings held in January for additional details.

We are convinced that nondiscrimination tests are too onerous and that their attendant rules of application are too complex for small employer group plans. Unless the rules are simplified so that small employers are able to understand and apply the tests, many so-called discriminatory plans will result.

Many of our customers are overwhelmed with the law's complexity. They tell us they will simply have the business owner pay the tax rather than attempt to collect the data and apply the tests.

We are also beginning to receive letters from small employer customers who are dropping their plans specifically because of section 89. Rules that are considered difficult for benefit experts to understand are incomprehensible for small employers without full-time benefit staffs or without the resources to hire benefits professionals.

Section 89 artificially imposes a new definition of part-time employee of 17½ hours per week on all employers and requires these employees be counted in testing. For many of our small business customers, this boils down to a forced financial choice of paying tax on their own benefits since the cost to expand coverage to all part-time employees is a significantly greater financial burden.

Small business owners who have voluntarily taken steps to provide health benefits to full-time employees may now be penalized by section 89 for failing to cover part-time employees when Congress has yet to decide on how best to encourage more employers to provide health coverage to their full-time workers.

A phase-in of part-time workers for the 80 percent test was included in last year's technical corrections as a result of the efforts of Senator Tom Harkin and Senator Charles Grassley. This phase-in should be expanded to apply to all tests.

A common characteristic of small employer plans, because of their limited financial resources, is a less generous employer subsidy for dependent coverage than is typically provided for employees' coverage. The mechanics of section 89 will require many small employers to take the additional step of testing the dependent coverage separately in order to pass.

Even though the subsidy is uniform for all employees, the affordability issue may cause difficulties in passing the tests. One practical alternative, confirmed by some of our own customers' actions, is dropping the subsidy for dependent coverage for all employees.

The new regulations issued recently add to the burdens of small employers rather than simplify the rules. Historically small employers have been required to satisfy the written plan rules prescribed by ERISA. The new regulations add a new layer of requirements on top of existing ERISA rules with little substantive difference in the end result. These new requirements will force small employers to incur additional expense for a new single written plan document and employee notice.

Furthermore, the regulation requiring a single written plan document appears in direct conflict with the conference agreement on qualification requirements that was included in the Technical and Miscellaneous Revenue Act of 1988. Although employers have until their 1990 plan year to satisfy this new plan document rule, a July 1 deadline provides little time to satisfy the new notice rules.

At the Principal Financial Group, we are helping our small employer customers cope with section 89 in a number of ways:

First, we have established a toll-free number for both our customers and their agents to call for help with section 89 questions. We received nearly 2,800 calls in the first 2 months of operation. The questions range from very basic to complex, but reinforce our view that the complexity of section 89 is contributing to a widespread lack of understanding on the part of small employers as well as their agents.

Second, we are also providing our customers and their insurance agents with educational question and answer materials and an informational packet designed to help them collect employee information and apply the tests. We are also helping by offering testing services.

As I indicated earlier, some policyholders are terminating their group plans rather than face the task of compliance. Others are considering this alternative.

One customer with nine employees in Dayton, OH, terminated his group plan and gave each employee an additional $1,500 in pay to go and find their own health benefits. We are quite sure that the cost to these employees for coverage will be higher than it would have been on a group basis if in fact they spend that money on health benefits.

Other examples of statements from policyholder letters include:

A 5-employee mining company in Arizona: "Our decision to cancel our group coverage was prompted by the IRS section 89 legislation."

A 9-employee hardware store in Florida: "Our cancellation is due to IRS ruling 89 which makes it necessary to cancel this company benefit."

A 19-employee company in Rhode Island: "The administrative requirements and penalty clauses of section 89 of the IRS code are too excessive to make continuation of this policy practical."

As we pointed out in our January 25 statement, we think a more appropriate alternative to discrimination testing for small employer groups is a safe harbor plan design. The advantages of allowing small employers to satisfy section 89 by virtue of plan design rather than by complicated testing far outweighs the disadvantages. The small group safe harbor represents a reasonable middle ground that would promote modest coverage expansion through broader availability of benefits.

Most importantly, it allows the small employer to avoid the costly and time-consuming task of applying the complex section 89 tests.

Furthermore, we are working with the section 89 coalition to develop other simplification proposals for consideration by both the House Ways and Means Committee and the Senate Finance Committee as well as with your committee. Thank you very much.

[Mr. Danilson's statement and statement of Principal Financial Group may be found in the appendix.]

Chairman LaFalce. Thank you very much, Mr. Danilson.

Because I have editorialized a bit throughout let me turn immediately for questions to Mr. Norman Sisisky.

Mr. Sisisky. Thank you, Mr. Chairman.

I do congratulate all of you. You have talked in language that I could understand and that is great.

Mr. Lubick, you said something that got me, and by the way, do all of you agree with the intent of section 89? You, Dr. Ture, said you did not, that you do not agree with the intent of section 89?

Dr. Ture. No.

Mr. Sisisky. OK. But most of you did. All right. You would not do away with section 89, you would——

Mr. Lubick. I would keep the number, Mr. Sisisky. [Laughter]

Basically, if you have a flat-out repeal without having an adequate working substitute I think you probably will never get the substitute.

I think what I proposed is a different animal from section 89. It is a limitation of the exclusion. It does not require testing. It basically as I said keeps the number.

Until that time, I think you might ask Mr. Danilson to put the toll-free number in the record.

Mr. Sisisky. I worry abou how complex this thing is. Mr. Kushner, you are a consultant. You testified about the problem section 89 poses for consultants. How can anyone understand this? Just consider the error rate of the IRS when answering questions on income tax, the error rate on a simple income tax form is 30 percent.

What do you think the error rate will be on the advice that you give to your clients, both lawyers, consultants, or the IRS?

Chairman LaFalce. What will this do to your liability insurance coverage?

Mr. Kushner. I first want to thank Congress for trying to ensure full employment of benefit consultants and attorneys in the field. But in all honesty, I must be the first person to come to Washington to testify against my own self interest.

Mr. Sisisky. I thought of that.

Mr. **Kushner**. Section 89, in terms of giving correct answers in such a complex area, my own belief is that there will be a number of consultants and attorneys and others who may not even be in the field.

I have concerns, for instance, about insurance agents who know about the sale of various insurance products but very often for small employers are relied upon for technical advice who may not be able to give accurate and complete advice in this area.

One of the significant problems that I see is the complexity of the law and the testing, and the very question that you raise.

To answer the chairman's question, I am not yet sure of what impact this will have on my liability coverage, if I can still find liability coverage after this. But I think that will be a problem.

Chairman **LaFalce**. The answer is, liability coverage in the future will not have any impact, there will simply be an exclusion for any advice about section 89.

Mr. **Kushner**. Correct.

Mr. **Sisisky**. Mr. Wood, you talked about a $435 million cost to county government to comply with section 89.

Mr. **Wood**. Local government, yes.

Mr. **Sisisky**. For local government to comply. Is that your estimate?

Mr. **Wood**. That was based on—in Duval County we are about 750,000, and I called the various independent agencies that we have plus our people in benefits and rolled all those together and then the staff at NACO checked with other counties and then we did an extrapolation of that to come up with that.

Mr. **Sisisky**. If that is just the expence falling on the counties, you are talking about $1 billion. You need not talk about that, if you take 28 percent of just $1 billion that is $280 million.

Mr. **Lubick**. That is deductible. That is 34 percent.

Mr. **Sisisky**. OK. Then 34 percent. So it is a deductible amount. If it is just the county's $435, you could be talking about $5 billion, we do not even know, which is deductible. I mean now we are trying to save money. This is what this is all about.

Chairman **LaFalce**. That is what I am arguing. Repeal of section 89 will raise money for the Federal Government.

Mr. **Sisisky**. But the worst problem that I see is what two or three of you said, that companies are going to drop their health insurance. Then where are the employees going to buy it?

Yes; a company can give employees $1,500 for health insurance. But what happens if the cost goes up 30 percent or 40 percent the next year? Are the employers then going to increase that $1,500? Now you and I know they are not. The real problem is that the younger workers without a family or other obligations are going to say well, I'll take the money and make a payment on my house, or on my car or something like that and choose to do without health insurance.

So where we are supposedly trying to help more people get health insurance, we are really doing some harm. Thank all of you for a very clear and concise statements.

Chairman **LaFalce**. Thank you very much. Congressman Hayes?

Mr. **Hayes**. Thank you, Mr. Chairman. I missed one witness I think.

As one of the 252 cosponsors——

Chairman **LaFalce**. 254 as of 1:59. [Laughter]

Mr. **Hayes** [continuing]. 254 cosponsors, I think I detect, and I am trying to get a consensus from the eight witnesses who testified here, I only heard one, I think that was you, Dr. Ture, who called for the burial of section 89.

The rest of them I think in one form or another indicated that it may be of some value for retention but you think it should be remodeled or something of that sort. Am I right?

Except you, as a consultant, you indicated—I do not know exactly what your position is. What is it?

Mr. **Kushner**. Mine?

Mr. **Hayes**. Yes.

Mr. **Kushner**. If I can address that, I think in representing ASPA here our position would be that repeal would be the ideal. But recognizing the practicality of the situation, if repeal is not forthcoming, then there need to be some significant changes made in section 89 both in the code and in the corresponding regulations. But repeal would certainly be ideal.

Chairman **LaFalce**. Dr. Ture, you wanted to comment.

Dr. **Ture**. Yes; please. Let me see if I can explain why I have an unqualified position in favor of repeal and why I think that section 89 was misfocused legislation at the outset.

I think there is a confusion of issues here. One issue is who gets what kind of compensation?

Another issue is what is the appropriate tax treatment for any element of compensation?

Now, it seems to me that first issue is one that belongs exclusively to the employee and the employer to resolve, and that, in all due deference, Congress does not have a role in designing and identifying the appropriate pay package for any employee in any kind of employment situation.

What Congress does have a role in and a role it should indeed assume is what is the appropriate tax treatment with respect to any element of the pay package? Section 89 does not do that.

Chairman **LaFalce**. Precisely.

Dr. **Ture**. I would call attention to the fact that back in, I guess it was mid-1981, when I was in the Treasury, we had some folks from the Department of Health and Human Services who were very much concerned about the then rapidly-escalating level of health costs and came in to negotiate with us for support of a proposal that would have imposed severe limits on the nontaxability or other tax sheltering of group health insurance plans. Their focus was entirely on putting a curb on the rise in health costs.

From the point of view of the Treasury Department, however much any one of us as policy makers might have been concerned about that, our appropriate policy concern was not that. It was rather, what is the appropriate tax treatment of those elements of compensation?

Though I as the Under Secretary in charge of this, who had responsibility in this area, was perfectly delighted for us to address that, we did not. The issue never was resolved. It still pends.

I would very strongly urge that section 89 has to be gotten out of the way. It is nothing but obfuscation, at enormous cost for employees generally, so that the issue properly identified and clearly identified can be effectively addressed.

Chairman LaFalce. Right; I want to associate myself with your remarks very much. Let us focus in on what the issue is, what the tax treatment ought to be for benefits that are given.

Now, if you want to say for example that benefits in excess of a certain amount should be taxed, well, that is not inappropriate under the Tax Code, is it, Dr. Ture?

Dr. Ture. It may or may not be.

Chairman LaFalce. Right.

Dr. Ture. I would rather finesse that for the moment by agreeing with the general proposition that you offer. There are enormously complicated issues of tax policy per se that should be identified and addressed if you are going to say here is the right way to treat——

Chairman LaFalce. I just want to say if somebody says, "OK, let us get rid of these absurd rules regarding discrimination and come up with something else that focuses on a totally separate issue; that is, excessive benefits, and label them both section 89," I would call that repeal and substitution.

I just want to explore if I may, Charlie, just one second here.

Mr. Hayes. Go ahead.

Chairman LaFalce. I will come back to you.

Mr. Hayes. Always yield to the chairman.

Chairman LaFalce. Thank you. Was there some internal debate within the Reagan administration? Were you there in November 1984 when Treasury 1 came out? What was your tenure there?

Dr. Ture. No; I left on June 30, 1982.

Chairman LaFalce. OK. So that was way before.

Dr. Ture. I had the great privilege of being able to be an absolute critic of section 89.

Mr. Sisisky. Would you yield?

Chairman LaFalce. Sure.

Mr. Sisisky. But were you there when ERISA came into effect?

Dr. Ture. No.

Mr. Sisisky. Because it had the same policy.

Dr. Ture. ERISA well predated my advent.

Chairman LaFalce. 1974. Charlie, go ahead. Do you have any further questions?

Mr. Hayes. Yes; one. Of the mayor of Schenectady.

I notice you represent, you are part of the Conference of Mayors. You are chairman of that group, am I right?

Ms. Johnson. I am chairman of the Subcommittee on Small Business.

Mr. Hayes. I see. Of that group?

Ms. Johnson. Of that group.

Mr. Hayes. Your views as expressed here represented only your views and not the National Conference of Mayors. I am trying to get at my own mayor's position.

Ms. Johnson. OK.

Mr. Hayes. I will be very honest with you.

Ms. Johnson. The conference is at this time gathering data on this issue and I think, if I may speak as a mayor, I have had hundreds of pieces of paper come over my desk regarding the need to comply with this and I have tried to put them off to other people and hope that I do not really have to deal with it because of the complexity.

But I think this is one of the things that we would like to point out is that mayors across this country and other local government officials do not even realize yet what is going to happen to them when they have to come into compliance and the tremendous cost burden this is going to be just to comply with the law.

Chairman LAFALCE. Yes; mayor, would it be fair to characterize it this way, at least based upon our conversations with the U.S. Conference of Mayors, that every mayor who is aware of section 89 is adamantly opposed to it although there may not yet have been an official formal meeting to have a vote cast to make it an official position of the National Conference of Mayors?

Ms. JOHNSON. I think it is fair to say what I stated is that we do not feel there has been discriminatory behavior in our sector of the economy and that local government should be exempt from section 89.

I think that if we were to ask the mayors the chances are very high we would have——

Chairman LAFALCE. Everybody affected wants to be exempt which would mean everybody is exempt. [Laughter]

You see, even the Treasury and IRS, when they came out with their regulations, exempted employers of 5,000 or more, which conveniently applies to the Federal Government.

I am not sure about their statutory authority for that, but they did it. So maybe the approach we should take is come up with a bill exempting those of 5,000 or less. It could still be on the books. We just exempt those above and below.

Mr. Campbell.

Mr. CAMPBELL. Mr. Chairman, I like that approach. I support it.

Not having had the benefit of hearing the testimony, I shall not ask any questions. I apologize for coming late. I was committed to another committee meeting.

But I do wish to commend you for holding these hearings and just add my voice. I can say the following without fear of contradiction, Mr. Chairman: In all my time as a Member of the House of Representatives, no issue has affected small business as deeply as this. Thank you.

Chairman LAFALCE. OK. Congressman Lancaster.

Mr. LANCASTER. Thank you, Mr. Chairman.

I was not able to be here to hear your testimony, but I have reviewed each of your statements in advance of the testimony and I do commend you for coming and for giving the cogent and important testimony that you have.

Mr. Lubick, in his testimony, made a proposal which I think is worthy of our exploring a little more because even though I am a cosponsor of repeal, my guess is that what we are going to be looking at is probably some modification rather than outright repeal. He has suggested as an alternative some sort of limitation on the deductibility of the value of benefits provided to highly compensated individuals.

I would like to ask the panel your thoughts on such a proposal as an alternative. If we went to that kind of proposal, at what level would you set the compensation? Second, how would you value the benefits? Last, would we simply be setting up a whole new set of questions about how to value, what the level should be, that sort of thing.

Mr. Lubick, you might start, since it was your idea, in responding to this question.

Mr. LUBICK. Quite clearly, I would use cost insofar as there is a cost under an insured plan.

Mr. LANCASTER. How about other——

Mr. LUBICK. When you get to the other type of plans, as it would be, if it is a self-insured reimbursement plan, I guess you have two choices.

One is either to use an actuarial valuation table which is something the Treasury has had a great deal of difficulty coming up with, although I expect some reasonable approximation might be done there, or a reimbursement of benefits which might be onerous on the employees.

I would, as I indicated, I would limit this only to the highly compensated, so you are dealing with a rather small group.

Mr. LANCASTER. You did not tell us at what level you would peg the highly compensated.

Mr. LUBICK. I would set the threshold at a high enough level to encompass most coverage. I suggested as one possibility 110 percent of what the Federal Government provides. But that is pretty rough. I do not see any point in intruding in very many plans.

If it is a level of benefits that you are providing generally, and I suggested that that ought to be part of it, then I think the necessity to provide the benefits for the rank and file is going to be a sufficient policing mechanism on employers so that they will not be doing this except out of what Norman calls the normal bargaining processes between employers and employees.

The cases you are trying to get at are essentially those cases where you may have a plan that is designed only for a few highly-compensated employees. I can see where that is taking advantage of the tax provision in a way that is not appropriate. It is to get at those cases of excesses and abuses without involving the whole system that I would go after.

For the most part, in major employers, I think you have cost figures that are available even though when you get into the very large plans you have in effect a form of self-insurance because you have retrospective determination of premiums based upon experience. But they are usually administered through insurance companies and you have a cost that is a surrogate for other type evaluation. It seems to me it is administrable.

We lived that way a long time before the 1986 act. As a matter of fact, in the 1978 act there was introduced a nondiscrimination principle with respect to reimbursements under self-insured plans that did not seem to disturb too much. Everybody was able to operate on the basis that most coverage was considered insured coverage and I would assume we would go back to that system.

But if you have to come up with an actuarial table for valuing benefits, the Treasury did do one a couple of summers ago in preparation for implementing these regulations. It had some glitches in it. But I would think you could do it on a rough and ready basis.

I do not think you have to be—this is one of the evils of section 89, is that they are trying to make sure they get every single last jot and tittle covered, and it just is not necessary, it is not cost efficient. It seems to me if you have something that is broad based to deal with the serious cases of excessive taking advantage of this tax expenditure, then we ought to be satisfied with that, even though we do not get everybody.

Mr. **Lancaster**. I would appreciate any of you who have ideas about this to comment. Yes, sir.

Mr. **Rohan**. If I may, I think the point, as I listen to all of this, may follow this, could follow this line.

If you go back to 1974 and ERISA, and the problem there was not one of taxing, it was one of discriminatory problems in pension plans, and while we all were upset, and probably there were panels like this then I am sure, deep down inside we all felt that there were probably bad practices out there that needed to be corrected.

While ERISA was called a lot of things, I think eventually we accepted it and we are living with it. It has not proven to be the big problem that we all thought it would be.

What you have in welfare benefits is not uniformly the problem that you had back with ERISA. There is very little major or significant or let us say very little discrimination in welfare benefits from plan to plan to plan across the industries of this country. That has not been the problem.

The problem probably is a tax problem of the highly compensated executives where they have created, and we have all done this, certain plans to handle certain high-paid people.

If that is the problem, then section 89 has just gone in the wrong direction and what we should be doing is saying all right, let us face up to that, and let us handle that one. The companies then, I tell you, will also handle that problem, with their own executives.

Mr. **Lancaster**. How?

Mr. **Rohan**. By grossing them up and paying the taxes. I mean, it is that simple. I think that is the problem, that we are chasing this thing, and it is very murky the way that we have gotten at it. I think it is basically kind of simple.

Chairman **LaFalce**. What you are saying is section 89 is going south and if we can get section 89 to go 180 degrees different, north——

Mr. **Rohan**. That is right.

Chairman **LaFalce** [continuing]. In the right direction, that would not be bad.

Mr. **Danilson**. Let me emphasize one point that the gentleman just made. That is, in the small- and medium-size employer situation, what we typically see is uniformity in the benefits that are available to the employees.

The individual owner of the hardware store has a single health benefits plan, and the same schedule of benefits is uniformly available to all employees, including himself, at a uniform employer subsidy. We are not talking about circumstances with executive-only medical plans.

Let me also add that this definition of highly-compensated employee needs to be taken into context for small business owners. We are not talking about people that make huge sums of money.

The individuals that are the owners of the business fall into that category. So somebody who may be earning $25,000 in salary, who has the same benefits as he offers to his rank and file employees, could be subjected to tax under the proposal that you suggest in terms of linking changes in section 89 to taxation on highly-compensated employees.

Chairman **LaFalce**. I do not even think you need to, if you are going to change directions, go to highly-compensated employees for substantive reasons.

You might have to for political reasons. But I think those would be poor reasons.

If say you had to raise $100 million or $150 million per year, there could be so many simpler ways to do that.

Yes; Dr. Ture and then Mr. Kushner.

Dr. **Ture**. Mr. Lancaster, I have to take exception to what many of my colleagues on this panel have offered.

I would be opposed to that approach altogether, because I think it finesses the basic question that has to be addressed and that is the question of what are the appropriate criteria to use. This is what I have been harping on throughout.

I think this approach that you have sort of outlined for us is the equivalent of condoning a little bit of sin. The sin is all right until it gets up to some critical mass at which point, bang, we ought to really come down hard on it. It is arbitrary.

Arbitrariness is the sine qua non of bad tax policy. I simply would not go that route at all.

I would repeal section 89 without any kind of reservation or caveat or qualification to it. Then I would say it is time to go back to square one.

Chairman **LaFalce**. It might be conceivable to do both in the same bill.

Dr. **Ture**. Sure; if an element of compensation in light of some relevant tax policy criteria that have not yet been identified, has been deemed to be appropriately tax sheltered, this should be tax sheltered irrespective of who gets it, whether that individual is highly compensated, so-so compensated, not so highly compensated.

I think one of the thrusts of your question is that there is an enormous difficulty that has to be confronted in trying to make these distinctions. There are not any analytical or conceptual or logical guides. You pick numbers off a clean, white ceiling. That tells you where to draw your lines. That is absurd. You ought to eschew that in tax policy to the greatest extent you possibly can. We have a lot of work to do, it seems to me, in this area. By virtue of section 89 we are focusing on a whole raft of problems. They are very serious problems. But they do not allow us to focus on what really should be at issue. We are not going to have that opportunity as long as section 89 is around.

Chairman **LaFalce**. That is why I think it is best to start off with a clean slate, because by starting off with a clean slate you can come in and ask the right questions.

Mr. **Kushner**. I agree wholeheartedly with your last statement, Mr. Chairman.

I would also like to just point out that we already do tax highly-compensated employees on their health insurance benefits, for all of those small employers who happen to elect a sole proprietorship form of incorporation.

Chairman LAFALCE. That is the vast majority.

Mr. KUSHNER. Which is the majority, and we tax them currently at 75 percent of their health care costs.

I agree wholeheartedly with the statements that we need to go back to square one, that we need to——

Chairman LAFALCE. I have a bill in that would cure that, too. The bill that I have in would apply the 100 percent deduction uniformly regardless of legal entity.

Clearly there is absolutely no rational justification for saying if you are incorporated and you have 10 employees you can deduct 100 percent and if you are not incorporated you can only deduct 25 percent. It is absolutely irrational.

Mr. KUSHNER. Yes; I think the whole thrust of what you may be hearing today and have heard in previous testimony in the past on section 89 is that the law is so onerous in and of itself that you need to strip it away and go back to square one and reexamine tax policy in the open, and call upon the employer community, call upon the consulting and legal communities to offer their expertise.

I certainly can say as a member of ASPA that personnel administrators would have had much to say in designing, in putting together simplified nondiscrimination rules. I think we need to go through that process as opposed to the process we now have seen incorporated.

Chairman LAFALCE. Thanks. Congressman Mazzoli?

Mr. LANCASTER. There is a gentleman at the other end who also would like to speak.

Chairman LAFALCE. OK.

Mr. WOOD. I would just like to echo Mayor Johnson's comment. I think in any reconfiguration of this bill that the public sector needs to be excluded.

We have historically been nondiscrimination oriented, and for all the reasons that applied back in 1974 when ERISA came through, I think that logic still holds, that basically when we have to come in with this expensive compliance, we have one or two ways of getting money and it all involves raising taxes to your constituents.

If it is ad valorem, that results right back in deductions back to the Government; if it involves income tax of some local groups that involves deductions back to the Government.

It seems to me like both of those approaches are counterproductive to what you were trying to do.

Chairman LAFALCE. Yes; I think there is valid grounds for your exclusion.

On the other hand, I think there is valid grounds for everybody's exclusion. We cannot say, if you have a collective bargaining agreement, you should be excluded. That only takes care of big business.

We could say, this should only apply to big business, therefore we shall exclude small business.

We could say, you should only exclude not-for-profits.

I think you have a valid case for exclusion. But I do not think we should look at it just from a narrow perspective. We have to say this is applicable to all employers in the United States of America.

Mr. **Wood**. Mr. Chairman, I agree with you. In my other life I am in the same business as Mr. Kushner, and own an employee benefit consulting and actuary firm. [Laughter]

It means money out of my pocket because we are under contract to help a few people with this.

But I think in the long run it is better for the overall group if we go back to the drawing board.

Chairman **LaFalce**. Good; Mr. Mazzoli has been hiding down there.

Mr. **Mazzoli**. Thank you very much, Mr. Chairman. I have been interested. I am a proud cosponsor from the first day of your bill. So I think that this panel only undergirds the wisdom of that bill.

I would like to ask just a couple of questions.

For the mayor of Schenectady, do you know when, Mayor Johnson, your colleagues will get together, or do you plan to get together for the purpose of ever taking a vote so that this position you articulate on your behalf and that of the city of Schenectady would be then felt to be that for the U.S. Conference of Mayors?

Ms. **Johnson**. The next opportunity we would have to adopt a resolution would be in June.

Mr. **Mazzoli**. Not until June. May I, without getting too much into it, and you may have said so in your statement, and I missed it, I am sorry, ask whether your position was determined in part by just conversations, casual, or was there a sitdown meeting of any kind, a telephone conference call or anything to yield this up?

Ms. **Johnson**. There have been extensive discussions of the staff and particularly in conjunction with the Government Finance Officers organization which does represent in a staff sense all these governments where the mayors may not have totally seen this as a problem yet. People that work for them as professionals see it as something that is coming that we are very concerned about.

Mr. **Mazzoli**. How about NACo?

Mr. **Wood**. Yes, sir. NACo has taken an official position. However, it was that public plans would be excluded. But following that same logic we——

Mr. **Mazzoli**. Right; let me just say just sort of parenthetically, it would be very important for us to have this information because I think it is very clear that when the mayors of the Nation and the county and local officials of the Nation do believe that this applied to them would be extremely burdensome and difficult, and I believe both of you testified, that it would be unnecessary because I think you both said in your judgment that is not the way cities and counties function, to be discriminatory.

I think it would be a very important influence on our colleagues, those 200 or so who may not yet have signed.

So I would hope that maybe some steps could be taken maybe in a part of the Conference of Mayors to bring this up on the table.

Mr. Kushner, I was interested in your several recommendations assuming that you cannot just totally repeal section 89.

Some of your things, you deal on point 2, and I did not get this exactly, but passage of section 125 tests should be made a safe haven for section 89 purposes. Section 125 I gather is a cafeteria plan, is that the idea?

Mr. **Kushner**. Correct.

Mr. MAZZOLI. Could you help me a little bit on that? Because I had a very interesting conversation with an accountant and benefit specialist at home 2 weeks ago.

His belief is first, that this section 89, if not changed, will force many, if not most, into cafeteria plans.

Do you believe that, just off the top?

Mr. KUSHNER. No; it probably will have the opposite effect in that if the current rules were allowed to let stand in the regulations, the proposed regulations were somehow issued then in final form.

Most cafeteria plans—even though reasonable people sitting around a table would say they are nondiscriminatory because they offer benefits on the same level and the same access with the same contributions to all employees, but the fact that some employees who for section 89 purposes may be nonhighly compensated happen to choose lesser benefit options under a cafeteria plan, and highly compensated coincidentally happen to choose higher options under a cafeteria plan even though everybody had the same choices going in, there was no discrimination—would fail the section 89 tests.

So if section 89 were left alone, I think that would probably discourage many employers, as opposed to encourage.

Up until 1986, and even to some extent still today, there were a series of nondiscrimination tests that a cafeteria plan had to meet and they applied both in terms of eligibility to participate in the cafeteria plan as well as the benefits coverage, the benefits that were offered in the coverage that employees receive.

There were tests that ensure that the highly-compensated did not receive a disproportionate share of benefit coverage under a cafeteria plan.

Cafeteria plans today still must meet those tests, but in addition they must now go, once passing those tests, to the section 89 tests and try to pass them all over again.

Mr. MAZZOLI. So tests that the cafeteria plans currently have to measure against are not totally sufficient. They still have to go beyond that and measure against the criteria of section 89. Is that correct?

Mr. KUSHNER. Correct.

Mr. ROHAN. Let me give you a practical problem in the health care industry. Approximately 80 percent of our workforce are female and many times they have spouses working elsewhere.

You put them underneath a cafeteria plan program and they will select out of a variety of the benefits because they do not need them. But when you test that plan under section 89 the chances of failing the discrimination part of it are very high because your workforce is not in the plant.

Mr. MAZZOLI. So even if people make a voluntary selection, from among the array of benefits available to them, that alone made freely is still possibly discriminatory.

Mr. ROHAN. That is right. Not only that, but where you have supplemental work forces who choose that kind of a work schedule as I said in my testimony——

Mr. MAZZOLI. I heard that.

Mr. ROHAN [continuing]. They say I do not want to pay for this benefit, and they select out, you have a real good chance of——

Mr. Mazzoli. When they opt out entirely because they want the money or something, they do not want the benefits.

Dr. Ture. Mr. Mazzoli, do you think a single hypothetical but still quite real world numerical example would help for this purpose? Let us consider an employee who works 20 hours a week so that he is above the 17½ hour exemption. A low paid employee, five bucks an hour.

On the assumption of a 50-week work year, that is 1,000 hours of work during the year, that is $5,000 gross wage, cash wage.

Now suppose this employee confronts the option of giving up some of that $5,000 in cash wages and take even a very rudimentary kind of health insurance plan that would not cost more than say $100 a month. I wish they were still available.

So that is $1,200 a year. He would have to take a 24 percent cash wage cut. I cannot think of very many employees in that kind of situation who would regard that as a deal. They would just reject it out of hand.

The employer cannot freely just add that $1,200 a year to his compensation, because he is not going to produce that much, contribute that much to the operation of the company

That employee faces either, if he is really under a section 89 kind of pressure on his employer to make sure the plans are qualified, he confronts either no job or a very substantial erosion of the kind of compensation he will depend on. It is entirely away from his choice, he would never freely opt for it, but think of the pressure put on him. I think this is absurd.

Mr. Kushner. Just to take that example one step further and put it into the section 89 context, let us say the employer now offers to the employee under the pro rata rules of section 89 to pay half of that $1,200 cost, $600, if the employee pays the other $600.

Under section 89 they could do that and be allowed to count that employee as a full employee for certain tests. Not all of the tests.

The employer will still get to one test where if the employee opted not to pay his $600 share even though the employer was prepared to pay $600, that I have to count that employee now as zero for my nondiscriminatory testing and if I had enough of those employees who opted out because they did not want to pay half of their share and I do not know a way to provide a half a health benefit, then I will fail my section 89 test.

It is this kind of almost perverse logic that section 89 puts on employers in all sectors.

Mr. Mazzoli. Can I just ask one last question, Mr. Chairman? I was in my office today and a person from home came by to talk on another line of business, but mentioned section 89 and heard of your hearings, and was very happy that you had been taking the leadership here.

He said that already there are certain computer programs on the market that have been advertised to people.

Are we making a mountain out of a molehill? Are there programs that people who understand these things can put in a computer and hit a couple of keys and out comes a printout and you solve the IRS problem? The doctor from Purdue?

Incidentally, I went to Notre Dame and we have had some titanic games over the years, I want to tell you. We appreciate the Boilermakers.

Mr. Ford. I wish it were so simple. The problem is gathering all the data and we found that we had to have some 50 data elements on each employee in order to run those tests. That is the kind of thing that takes so much time.

Once you get the data in your data base, sure it is relatively simple to run it through somebody's computer program——

Mr. Mazzoli. That is a very good point.

Chairman LaFalce. Then you have to redo the data every year do you not?

Mr. Ford. That is right, you have to test it each year.

Mr. Mazzoli. So this isn't just a one-time shot and you are there in perpetuity. You do it every year.

Mr. Ford. The outcomes may change.

Mr. Mazzoli. That is an interesting point, Mr. Chairman, and I am glad you mentioned that, that there would be 50 separate data bases or whatever you would say about every piece of information about any single employee and that has to be cranked in and you have thousands I am sure at West Lafayette.

Mr. Ford. Right. There are something like 10,000.

Mr. Mazzoli. Ten thousand. That would be true across the board. I am sure the hospitals have tens of thousands.

Mr. Rohan. Now take his Purdue situation and they find out at Purdue that instead of one plan because of the way that they have to check for discrimination they have 50 plans because the one plan is no longer one plan.

Mr. Mazzoli. So you will have 10,000 employees, 50 pieces of information spread over 50 different plants tested 50 separate times.

Mr. Ford. We had 100 different plans.

Mr. Mazzoli. You wound up with 100 different plans.

Mr. Ford. One hundred plans had to be tested when we ran the test.

Mr. Mazzoli. I think the panel has been an extremely interesting one and I think have made a very, very careful, thoughtful, nonhysterical case that what we have here is a good thing gone amok, in that we probably have to just in mercy kill it and then get it out of its misery and our misery and then start with all of the very interesting suggestions several of you have had and other people like you will have on how to overcome discrimination. If there is discrimination, the chairman said at the very first day of our hearing, if there is discrimination, if people who are more highly compensated than others are reaping all the benefits, then we do not want that to happen.

In the little that I know about this, it just seems to me there ought to be a better, simpler, more coherent way to get this information together.

Mr. Chairman, I thank you all very much.

Chairman LaFalce. I can see your local papers tomorrow: "Mazzoli switches, favors euthanasia." [Laughter]

Mr. Mazzoli. This is one time where the death penalty is probably one we can all support.

Chairman **LaFalce**. Good; I want to thank each and every one of you. I thought your presentation was uniformly excellent. It is going to be of great interest to me as I peruse this and I know it is also going to be of great interest to the members of the Ways and Means Committee, because their chairman, Dan Rostenkowski, has expressed great interest to me in the results of our hearings and in the approaches that are taken by the different panelists.

So we thank you all very much.

[Whereupon, at 4:20 p.m. the committee was adjourned.]

APPENDIX

SILVIO O. CONTE
First District, Massachusetts

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Opening Remarks
of the Honorable Silvio O. Conte
Hearing on Internal Revenue Code Section 89
January 24, 1989

Mr. Chairman, I commend you for holding hearings on Internal Revenue Code Section 89 in the very early days of the 101st Congress. From this early scheduling, it is apparent that you intend to pursue a vigorous small business agenda this Congress and I fully support that. The Small Business Committee is and should be the most exciting committee in Congress.

Internal Revenue Code Section 89, which was part of the 1986 Tax Reform Act, Public Law 99-514, requires employers to provide similar benefits to all their workers regardless of pay. It also requires employers to insure that workers at all pay levels take equal advantage of the benefits offered. While the concept is good, implementation could be a legal nightmare for small business, particularly with regards to testing. It could also prove disastrous for employees. If, for instance, after comprehensive testing, a company found it was not in compliance with the law, it could conceivably scrap its benefits plan altogether to avoid the threat of financial sanctions. Probably the only beneficiaries of Section 89 would be the Federal government and lawyers - certainly not small business and their employees.

While Section 89 was subsequently clarified by technical corrections in Public Law 100-647, little was done to address the fundamental concerns of small business. Although required by the Technical Correction Act to issue regulations by November 15, 1988, the IRS has not yet done so, no doubt because of the complexity of the issue.

Beside the overall issue of mandated benefits, basically for small business Section 89 revolves around two issues, collection of data, and the cost, if any, to the company and employees of compliance. Absent IRS guidelines and confronted with a statute of enormous complexity, I believe it only fair and proper that the Small Business Committee act to repeal this law and that is why I have cosponsored legislation to do so. I believe we should study the issue in committee to determine if a problem exists and, if so, how to better address it without placing another undue burden on America's small businesses.

I look forward to today's hearing and to the testimony of our distinguished panel.

OPENING STATEMENT OF HON. JAMES BILBRAY
BEFORE HOUSE SMALL BUSINESS COMMITTEE--1/24/89

MR. CHAIRMAN, I WISH TO TAKE THIS MOMENT TO WELCOME BACK MANY OF MY FELLOW COLLEAGUES WHO SIT ON THIS COMMITTEE, AND TO CONGRATULATE THEM ON A VERY SUCCESSFUL AND PRODUCTIVE 100TH CONGRESS.

I AM CONFIDENT THAT THE 101ST CONGRESS WILL PROVE TO BE AS EFFECTIVE AND PRODUCTIVE FOR THE SMALL BUSINESS COMMITTEE AS WAS THE 100TH CONGRESS. ALTHOUGH WE WILL BE DEALING WITH MANY DIFFICULT ISSUES, SUCH AS HEALTH CARE, FAMILY AND MEDICAL LEAVE, MINIMUM WAGE, AND DAY CARE, I HAVE TOTAL CONFIDENCE IN THIS COMMITTEE AND IN THE ENTIRE CONGRESS TO ADDRESS THESE ISSUES IN A THOUGHTFUL AND RESPONSIBLE MANNER.

TODAY'S HEARING, DEALING WITH EMPLOYEE BENEFITS, IS PERHAPS ONE OF THE MOST IMPORTANT ISSUES THAT WE WILL FACE. IT ENCOMPASSES MANY OF THE ISSUES THAT I JUST MENTIONED, SUCH AS HEALTH CARE, PARENTAL LEAVE, AND CHILD ARE. I LOOK FORWARD TO AN INFORMATIVE HEARING AND AN EXCITING AND PRODUCTIVE 101ST CONGRESS.

Small
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TESTIMONY OF

Wayne J. Smith
Chairman

Small Business Legislative Council

Before

The Committee on Small Business

U.S. House of Representatives

January 24, 1989

1025 Vermont Avenue, NW/Suite 1201/Washington, D.C. 20005/(202) 639-8500

Good morning. My name is Wayne J. Smith, Chairman of the Small Business Legislative Council and Executive Director of the United Bus Owners of America. We appreciate the opportunity to testify today and look forward to working with this committee once again during the 101st Congress. We only wish that we could begin the new Congress on a more positive note.

The subject today is Internal Revenue Code Section 89. As you know, Section 89 is the child of the Tax Reform Act of 1986 (TRA), a law which we viewed with considerable doubt at the time of passage. The emergence of Section 89 as a problem for small business only serves to reinforce our belief that, lower rates notwithstanding, TRA was, and is, the source of substantial heartburn for most small business owners.

The Small Business Legislative Council (SBLC) is a permanent, independent coalition of over ninety trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of over four million small businesses in manufacturing, retailing, distribution, professional and technical services, construction, transportation and agriculture. A list of our members is attached.

The first, and most logical question to ask, is why are we here today if Section 89 was enacted over two years ago? The answer is that the debate over tax reform was an important one for small business, and quite frankly most of us in the small business community devoted what resources we had to other issues related to tax reform. Second, in our many years of work for, and with, small businesses, we have come to learn that you deal with those things today which affect the bottom line today. Fighting tomorrow's battles frequently take a back seat. While this is not an excuse, it is a reality within which we must work.

Third, and most importantly, from what we observed during the debate on tax reform, we are not convinced that more than a handful of individuals on Capitol Hill and at Treasury had any idea what Section 89 was all about at the time of passage. It appears to us that the Section 89 controversy has all of the same elements of the auto-log fiasco of just a few short years ago. The concept sounds good, but no one had the time to consider fully the complexities of implementation or the ramifications of compliance and enforcement. The effective date as rolled around, and we are forced to address the problem head-on.

One thing is certain, Section 89 is, and will be, a problem. We find it ironic that the IRS, with a two year lead time, failed to issue comprehensive guidance before the effective date even after Congress prodded it to action by imposing a specific date, November 15, 1988, for issuance of the regulations. Yet still small businesses are expected to comply.

We believe our problems with Section 89 can be divided into three categories -- our disagreements with certain fundamental statutory assumptions of the section, questions of interpretation, and matters that could easily be resolved by better planning and communication by the government.

It has been our philosophy, in recent years, to make every effort to disseminate information to small business on new regulatory programs as quickly as we can. We do this through compliance guides and seminars. The Immigration and Naturalization Service's (INS) I-9 program and OSHA's Hazardous Communication (HCS) program are two examples of program for which SBLC undertook major education initiatives. We believe it is our responsibility to accept the mantle of leadership and promote cooperation between the government and small business. On occasion, our efforts to educate reveal the flaws in these regulatory schemes. Today, we offer our comments on Section 89 with the voice of experience.

We have prepared a compliance guide to Section 89 and have already held one seminar on the subject. The guide, a copy of which is appended, is in draft form because we had hoped that the IRS regulations would fill in many of the interpretative gaps. It is our understanding that the forthcoming regulations may not be the comprehensive guidance small businesses need to comply with Section 89. The results of our seminar, our work on the guide, and the thousands of calls received by our 93 member associations from their small business members lead us to the following observations.

In the category of disagreements with the statutory concepts behind Section 89, putting aside the question of whether the government should regulate benefits, the most dramatic and unprecedented change brought about by Section 89 is the premise that individuals working 17 and one-half hours or more a week are to be considered employees for the purpose of benefits. This is a startling expansion of the concept of employment, with ramifications for not only this program, but for other potential government imposed responsibilities. The 1988 Technical Corrections Act included a special two-year transition rule on this point, but it does nothing to lessen the impact of this unprecedented expansion. We fear it may lead to the elimination of the part-time jobs, essential points of access into the work force for many individuals.

Second, we believe any regulatory scheme should allow small business owners an opportunity to bring their programs into compliance. Whether it is the OSHA HCS program or Section 89, the penalties should be prospective, contingent upon failure to comply within a certain time frame once an agency has served warning upon the individual company.

With regard to questions of interpretation, the laundry list of our concerns is long. We offer the following examples to illustrate the breadth and depth of interpretative problems. What is meant by the term "plan?" In 1986, Congress said, "Each different option generally is a separate plan for testing purposes. This means, for example, that if two types of insurance coverage vary in any way (including the amount of required employee contributions), they are considered separate plans." In 1988, Congress amended Section 89 in the Technical Corrections Act, and said, "Each different option is valued separately, but is not considered a separate plan. A plan is a group of options with comparable values (under otherwise applicable comparability rules). With respect to the non-discrimination rules, the effect of these changes is only one of terminology rather than of substance." SBLC is not convinced that a small business owner will be able to make the distinctions necessary for compliance.

A second example of interpretative challenges confronting small business is the so-called 80-percent alternative test, which in theory is a safe harbor. We have found it exceedingly difficult to simplify the explanation of this safe harbor. As we understand it, the rule reads as follows:

> For purposes of the 80-percent test, a group of plans are comparable and may be aggregated if the value of the employer-provided coverage provided to each covered employee in the plan with the lowest such

value is at least 90 percent of the value of the employer-provided coverage provided to each covered employee in the plan with the highest such value. The comparability standard is reduced to 80 percent if the employer elects to apply the 80-percent test as a 90-percent test.

For purposes of the 80-percent test, a plan with a value greater than that permitted under the general comparability rule may be aggregated with a group of less valuable comparable plans if the employees covered under the plan with the greater value is at least 80 percent (90 percent if the 80-percent test is applied as a 90-percent test) of the percentage of highly compensated employees covered under such plan.

Comparability Safe Harbor - a) Under the general safe harbor rule for purposes of the 80-percent test, a group of plans is treated as comparable with respect to a group of employees if:

(i) such plans are available on the same terms to all employees within the group, and

(ii) the difference in annual cost to the employees between the plan in the group with the smallest employee cost and the plan with the highest employee cost is not more than $100.

Any other plan may be aggregated with the group of plans in (a) if such other plan is comparable under the general comparability range to the plan within the group with the largest employer-provided benefit.

A plan may also be treated as comparable to the group of plans described with respect to an employee if:

(i) in the case of a non-highly compensated employee, such employee is eligible under the plan within the group with the largest employer-provided benefit

(ii) in the case of a non-highly compensated employee, the employee contribution permitted with respect to the group of plans under the general safe harbor, and

(iii) the employer-provided benefit under the plan outside the group is less than the employer-provide benefit under the plan within the group with the largest such benefit (without taking into account any plans aggregated under (b) above).

Family coverage and coverage-elsewhere rules also raise several questions of interpretation. One is, what benefits are to be considered "core" benefits used to determine whether there is sufficient coverage elsewhere? So far, as we know, the term "core benefits" has not been defined. The only clue to date are legislative history references to items that are not benefits, such as: dental, vision, psychological, orthodontia and elective cosmetic surgery. We are reminded of the comment of one Supreme Court Justice, defining pornography as "I'll know it when I see it."

We have heard it said that, as the result of changes in the 1988 Technical Corrections Act, employees who do not have dependents are not counted in applying the discrimination test to family coverage. What we find in the legislative history is something slightly different. According to the record, an individual is counted as having received the coverage with some caveats. Thus, for example, if coverage of an employee's spouse and dependent(s) is non-contributory and the employee does not reject the coverage, such employee is considered to receive coverage of his or her spouse and dependent(s) without regard to whether he or she has a spouse or dependent(s). If coverage of an employee's spouse and dependent(s) is contributory and the employee makes the required contribution, such employee is considered to receive coverage for his or her spouse and dependent(s) without regard to whether he or she has a spouse or dependent(s). Of course, in such case, if the employee does not make the required contribution, the employee is not considered to receive coverage for his or her spouse and dependent(s), if any.

Under the qualification rules of Section 89, whenever an employer provides a benefit under:

a) a statutory employee benefit program;
b) a qualified tuition reduction program;
c) a cafeteria plan;
d) a fringe benefit program such as those providing no additional cost services, qualified employee discounts, or employer-operated eating facilities; or
e) a voluntary employee benefit association (VEBA)

Then the employer must ensure that:

a) the plan is in writing;
b) the employee's rights under such plan are legally enforceable;
c) the employees are provided reasonable notification of benefits available in the plan;
d) such plan is maintained for the exclusive benefit of employees; and,
e) such plan was established with the intention of being maintained for an indefinite period of time.

Our questions regarding the interpretation of these qualification rules include what constitutes a written plan. From the legislative history, we have been able to ascertain that a written plan does not require a single document, and should include a description of each benefit available; the names of the trustees or other fiduciaries of the plan; the class of employees eligible to participate; and, a statement that the plan is for the exclusive benefit of the covered employees.

How does a business owner determine what constitutes an indefinite time? We have been able to determine that while plans are to be established for an indefinite period, plans may be terminated for business necessity reasons such as insolvency, bankruptcy, sale of the business, and proven financial inability to continue the plan. What constitutes an indefinite period needs further clarification.

One final example of the interpretative questions posed by Section 89 involves the process of determining the discriminatory excess. In the event a plan is found to be discriminatory, calculation of the amount considered to be discriminatory is the ultimate challenge. The following example, included in the conference report, will allow you to judge for yourself whether a small business can be expected to comply with Section 89.

Example 1 - Assume that for 1990, the following facts exist:

DETERMINATION OF DISCRIMINATORY EXCESS

Employee	Employment during 1990	Employer provided benefit	Testing value
A	1/1-6/30	$ 500	$1,000
B	1/1-12/31	1,000	1,000
C	1/1-12/31	1,500	1,500
D	2/1-12/31	1,375	N/A
E (highly compensated)	1/1-6/30	900	1,800
F (highly compensated)	1/1-12/31	1,800	1,800
G (highly compensated)	2/1-12/31	917	N/A

Assume further that there are no changes in plan design or changes in highly compensated employees' elections during 1990.

The employer-provided benefit column provides the actual employer-provided benefits received by each employee during 1990. The testing value column provides the annual value of the employer-provided benefit that each employee receives on the testing date. This testing value is determined by taking into account the actual employer-provided benefit for each employee who is employed on the testing date, but adjusting such benefit to the value of the benefit as if it were provided for the entire testing year. It is this value that is used for purposes of applying the 75-percent test. There are no testing values for D and G because they are not employed on the testing date and thus are disregarded for testing purposes.

Based on these facts, for purposes of the 75-percent benefits test, the average employer-provided benefit for the non-highly compensated employees is $1,167 [($1,000 + $1,000 + $1,500)/3]. The average employer-provided benefit for the highly compensated employees is

$1,800 [($1,800 + $1,800)/2]. In order to satisfy the 75-percent test, the average employer-provided benefit may not exceed $1,556 ($1,167 /.75). Thus, there is a discriminatory excess under the 75-percent test.

Once an employer determines that there is a discriminatory excess under the plan, the employer is required to determine the actual employer-provided benefit for every highly compensated employee, including those not employed on the testing date, and apply the tests based on such data. This calculation may result in an increase or decrease or even an elimination of the discriminatory excess. The average employer-provided benefit for non-highly compensated employees is not recalculated.

For example, under the above facts, the average employer-provided benefit for the highly compensated employees is $1,497. This is determined under the present-law rules applicable for purposes of the 75-percent test (i.e., by including the actual employer-provided benefit in the numerator and counting an employee as less than a full employee in the denominator if such employee is not employed for the entire year). In this example, E is 1/2 of an employee and G is 11/12 of an employee. Thus, the average employer-provided benefit for the highly compensated employees is calculated as follows:

($900 + $1,800 + $917) /(1 + 1/2 + 11/12) = $1,497. Because $1,497 is less than $1,556, there is no discriminatory excess under the 75-percent test.

Assume, however, that G's actual employer-provided benefit is $1,650, rather than $917. In this case, the average employer-provided benefit (based on actual data) for the highly compensated employees is $1,800. This amount is calculated as follows: ($900 + $1,800 + $1,650) / (1 + 1/2 + 11/12) = $1,800. Because $1,800 is above the maximum permitted average for the highly compensated employees of $1,556, there is a discriminatory excess, and it is necessary to allocate the excess among the highly compensated employees.

The amount of the discriminatory excess is determined and allocated as follows. First, the total discriminatory excess for all highly compensated employees is determined by (1) calculating what the total employer-provided benefit for all highly compensated employees would be if the average employer-provided benefit for such employees satisfying the benefits test, and then (2) subtracting the amount in (1) from the total actual employer-provided benefit for all highly compensated employees.

In the example, the calculation of the total permitted employer-provided benefit for highly compensated employees is $1,556 x (1 + 1/2 + 11/12) = $3,760. Then this amount is subtracted from the

> actual employer-provided benefit for the highly compensated employees to obtain the total excess of $590 as follows: ($900 + $1,800 + $1,600) - $3,760 = $590.
>
> To allocate the $590 of discriminatory excess among the highly compensated employees, F's benefit is reduced first, because F has the highest employer provided benefit. Thus, F's other wise nontaxable employer-provided benefit is reduced by $150, to the level of G's employer-provided benefit. Then, F's and G's benefits are reduced equally until the remaining $440 of excess ($590 - $150) is allocated. That is F's benefit is reduced by an additional $220. Thus, F's total nontaxable benefit is $1,430 ($1,800 - $150 - $220), as is G's ($1,650 - $220). A total of $370 ($150 + $220) is includible in F's income, and a total of $220 is includible in G's income.
>
> The benefit is includible in income in the employee's taxable year in which, or with which, the plan year ends, but if the testing year ends after September 30, and on or before December 31, an employer can elect to include it in the employee's next taxable year but the employer must take the deduction for that amount in its taxable year that follows the taxable year in which the testing year ended.

The final problem we have with the Section 89 is the lack of effective communication by the government. Congress and the IRS must ensure that small business owners understand their responsibilities before the effective date and this communication must consist of more than notice of the effective date. While not perfect, the INS' I-9 program is a good model of how to communicate. The INS did undertake a major effort to inform the business public of the requirements through the dissemination of written and video material. In fact, if I recall correctly, the INS used the IRS list of business establishments for distribution of this information.

In the case of Section 89, there are some ways to reduce the likelihood of mass hysteria. For example, most small business owners automatically assume Section 89 applies to all benefits. They assume it applies to automobiles, vacations, tickets to events or memberships in clubs. Clear, simple information, in advance could eliminate some major headaches. Unfortunately, small businesses are still working to comply with the relatively recent changes in fringe benefit rules, and in many instances do not fully understand which benefits are includible or excludible from the employee's income. This confusion includes the proper application of definitions of working condition fringes and de minimis fringes. For this reason, we found it necessary to describe the fringe benefit rules in our guide. We believe early dissemination of this type of information is essential.

Realistically, no amount of change will make Section 89 an easy test with which to comply. It seems to us that Congress rarely says, "Thou shall not do the following..." Instead, it appears drafters attempt to anticipate every possible way to circumvent the law, plausible or implausible, and include language to prevent such activity. The results are laws too complicated that penalize owners, who in good conscience, wish to comply. A recent law suffering from the same phobia that comes to mind, is the plant closing notification act. The irony is that complicated regulatory requirements create an underground community of owners who say, "This is just too difficult, I'll take my chances and wait to see if they catch me." We do not want that to happen and we believe most small business owners do not want it. We know some owners will eliminate jobs in reaction to Section 89. Others will simply eliminate every employee's benefits. The way to ensure compliance is to be realistic and flexible in the development of laws and regulations. Is that not why this Committee was instrumental in the passage of the Regulatory Flexibility Act? We believe it is time Congress applied the Regulatory Flexibility Act to itself. Specifically, we believe it is time for Congress to require standing committees to undertake a careful economic impact of proposed legislation upon small business before the committee votes on legislation. In the last Congress, such a proposition gained some attention in the midst of the debate over various labor bills. We submit that if Congress undertook the economic analysis of the type required by the Regulatory Flexibility Act there would be no section 89's.

We find a new undercurrent within the small business community. Under the patina of optimism, lies a layer of frustration. For the first time in a decade, we have heard small business owners suggest the price of doing business is just too high, and the price of doing business is paperwork and regulation. In this nation, we believe entrepreneurship has perfect elasticity; that is, no matter what the cost of entry, more Americans will want to own the American dream. It may not be so. A few examples of the relatively new regulatory schemes with which small business must comply include the I-9 program imposed by the Immigration Reform and Control Act, the Hazardous Communication Standard program, the underground storage tank program, the hazardous waste program created by the RCRA, several other tax compliance items, such as the passive/active rules, new transportation licensing requirements, plant closing notification rules, polygraph-use restrictions and notice, and new credit card disclosures. State and local governments have also initiated unprecedented oversight of business.

The level of regulation and the business reaction has forced us to launch a new effort within our organization. We have started a new task force on regulation and paperwork to identify and address these problems.

We do not want to be whiners. Small business has always taken the attitude, "We'll survive it." The question to ask is -- if small business is so important to our economy, why do we always force the question? Let's let them go about the business of doing business, not government homework. Thank you.

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UNRAVELING THE MYSTERIES OF SECTION 89:

A Business Owner's Guide to Providing Employee Benefits Under The Tax Code

SMALL BUSINESS
LEGISLATIVE
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INTRODUCTION

In 1986, Congress made the decision to encourage employers to provide benefits to all workers, equally, regardless of compensation. The result of Congress' efforts is Section 89.

Simplicity and complexity are in the eyes of the beholder. Like many regulatory schemes, Section 89 is written to take care of the extremes, rather than the commonplace. This guide is for informational purposes only. It is not a substitute for legal or accounting advice. Many pages have been written about those rules. One whole set of regulations is needed just to explain compensation. In writing this guide, we chose the middle path. We chose to highlight the typical situation.

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For many businesses, Section 89 may require very little except a few minutes of thought and planning. If you have some doubts, or offer sophisticated benefits, hopefully this guide will at least identify the questions you need to ask, and we recommend you seek further guidance from counsel.

The Technical Corrections Act of 1988 directed the U.S. Department of Treasury to issue comprehensive guidance with respect to Section 89 by November 15, 1988. Treasury was unable to do so. Without such regulations, it will be difficult for any business owner, with limited resources, to comply with Section 89. This guide was written on the basis of the law and legislative history, but any guide to Section 89 will have its shortcomings without the benefit of Treasury guidance.

Congress itself recognized the dilemma and apparently anticipated the likely inability of Treasury to issue comprehensive guidance. It said, "Pending the issuance of what the Secretary determines to be comprehensive Section 89 rules on which taxpayers may rely, the good faith compliance provisions will continue to apply to any issue not addressed by rules issued by the Secretary."

A taxpayer will be found to be *not* acting in good faith if the taxpayer consistently resolves unclear issues in his or her own favor. Taxpayers are expected to make reasonable interpretations of Section 89 based on the statute for which there is no guidance issued by the IRS.

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"This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought."

CHAPTER I:

WHO'S COVERED

Our objective is to simplify as much as possible, the process of compliance therefore the following basic questions will lead you to the appropriate chapters, and hopefully may relieve you of any further reading.

Do you offer any benefit of any kind to any employees that is not included in the employee's gross income (if you are self-employed, you are an employee for these purposes)?

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If the answer is no, close the book and relax, Congress did not make your life any worse today. If the answer is yes, proceed to the next question.

Do you offer any of the following benefits?:

accident plan
health plan
group term life insurance
qualified group legal services
education assistance plan
dependent care assistance plan

If the answer is yes, we are sorry to report that hard work is ahead of you. This book is written principally for you. If the answer is no, but *you do offer other fringe benefits* such as employee discounts or employer-operated eating facility, ***please read only Chapter II.***

Do you participate in a multi-employer plan, operate separate lines of business or maintain multiple facilities? *Do not overlook Chapter VI.*

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Do you offer a package of benefits from which employees choose (cafeteria benefits plans)? *Do not overlook Chapter VI.*

CHAPTER II

ALL BENEFIT PROGRAMS — QUALIFICATION RULE

BASIC REQUIREMENTS

Whenever an employer provides a benefit under:

a) **a statutory employee benefit program (*see Chapter III*);**

b) **a qualified tuition reduction program;**

c) **a cafeteria plan (*see Chapter VI*);**

d) **a fringe benefit program such as those providing no additional cost services, qualified employee discounts, or employer-operated eating facilities; or**

e) **a voluntary employee benefit association (VEBA)**

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Then the employer must ensure that:

a) **the plan is in writing;**

b) **the employee's rights under such plan are legally enforceable;**

c) **the employees are provided reasonable notification of benefits available in the plan;**

d) **such plan is maintained for the exclusive benefit of employees; and,**

e) **such plan was established with the intention of being maintained for an indefinite period of time.**

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FRINGE BENEFITS

It is essential to remember that this qualification rule applies only to those fringe benefits that are *excludable* from the employee's gross income under the tax law.

It is important for employers to remember that certain benefits must be reported as income to the employee under other sections of the tax code, but, as a result, are not subject to the Section 89 qualification rule.

Examples of fringe benefits includable in gross income, and therefore not subject to the Section 89 qualifications rule, are:

- **An automobile**
- **A flight on an employer-provided aircraft**
- **A free or discounted commercial airline flight**
- **A vacation**
- **A discount on property or services**
- **A membership in a country club or other social club**
- **A ticket to an entertainment or sporting event**

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Examples of fringe benefits that may be excludable from income and therefore subject to the Section 89 qualification rules are:

- **A no-additional-cost service**
- **A qualified employee discount**
- **A working condition fringe**
- **A de minimis (minimal) fringe**
- **Certain athletic facilities**

If you offer an employee a service free of charge or at a reduced price that is the same service you offer to non-employees in the ordinary course of the line of business in which the employee works, this service is considered a *no-additional-cost* service and may be excludable from the employee's income. You cannot incur substantial additional cost, including lost revenue, in providing the service to an employee. Examples of these services are: excess airline, bus, or train tickets, unused hotel rooms, or telephone services provided free or at a reduced price to employees working in those lines of business.

Generally, an employer's line of business is determined by reference to the Enterprise Standard Industrial Classification Manual (ESIC Manual) prepared by the Statistical Policy Division of the U.S. Office of Management and Budget.

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Employees may be able to exclude no-additional-cost service benefits provided by another employer in the same line of business if you and the other employer have a written *reciprocal agreement* and the no-additional-cost service requirements are met. For example, two related airlines provide free space-available flights to each other's employees. If the requirements of a no-additional-cost service listed above are met, the value of the flights can be excluded from the recipient employees' income.

A *qualified* employee discount is a reduction in price that you offer employees on certain property or services that you offer to non-employees in the ordinary course of the line of business in which the employees perform services. Personal property held for investment or real property does not qualify for a discount. The discount (for property) may not exceed your ***gross profit percentage*** and, for services, may not exceed 20 percent of the price at which the service is offered to non-employee customers. The gross profit percentage is determined on the basis of all property offered to customers (including employee customers) in the ordinary course of your line of business, and your experience during a representative period. To figure the gross profit percentage, subtract the total cost of the property and divide the remainder by the total sales price of the property.

Any property or services you provide to an employee may be excludable as *working condition fringe benefits* to the extent the employee could deduct them as business expenses had the employee paid for them. If the payment would be deductible in a business of the employee, other than your business, you cannot treat the payment as a deduction for purposes of determining the amount, if any, of the working condition fringe. Also, the value of parking facilities provided to employees on or near your business premises may be excluded even though not deductible by the employees.

A *de minimis fringe* is any property or service you provide to an employee (taking into consideration how frequently similar fringe benefits are provided to your other employees) that has so small a value as to make accounting for the benefit unreasonable or administratively impracticable. Examples: typing of a personal letter by a company secretary; occasional personal use of a company copying machine; monthly transit passes provided at a discount not in excess of $15; occasional parties or picnics for employees; occasional supper money and taxi fare for employees working overtime; holiday gifts with a low fair market value; occasional tickets for entertainment events; and coffee or doughnuts furnished to employees.

The value of meals provided to your employees at an employer-operated eating facility may be considered a de minimis fringe, if the annual income from the facility normally equals or exceeds the direct operating costs of the facility. For more information, including definitions of an employer-operated eating facility and direct operating costs, see the IRS' Valuation of Meals Provided at an Employer-Operated Eating Facility for Employees.

Your employees can exclude from gross income the value of an *on-premises gym or other athletic facility* provided and operated by you if substantially all the use during the calendar year is by employees, their spouses and their dependent children. The value of the use of country clubs or health clubs that are open to the public is not excludable unless the above requirements are met. The exclusion does not apply to any athletic facility that is a facility for residential use. For example, a resort with athletic facilities would not qualify.

EXPLANATIONS

For most small employers, compliance will be required as a result of a statutory employee benefit plan such as a health plan, or a fringe benefit such as an employee discount.

In 1989, the written plan requirement will be met if the plan is in writing before the close of such year, the employees had a reasonable notice of the plan's essential features on or before the beginning of the plan year, and the provisions of the plan apply for the entire year.

The written plan requirement does not require a single stand-alone document. It may be a collection of documents.

"Legally enforceable" generally means the employer does not have the discretion to withhold benefits. For example, a plan says medical expenses will be reimbursed at the employer's discretion does not meet the "legally enforceable" test.

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The written plan should include items such as:

A description of each benefit available

The names of the trustees or other fiduciaries of the plan

The class of employees eligible to participate

A statement that the plan is for the exclusive benefit of the covered employees

Although the rule requires that plans be established for an indefinite period of time, plans may be terminated for business necessity reasons such as:

insolvency
bankruptcy
sale of the business
proven financial inability to continue the plan

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REPORTING REQUIREMENT

If the employer fails to meet the test, the value of the benefits is includible in the gross income of the employee (*see chapter VII*). In such a case the amount must be separately stated on the employee's W-2.

SANCTIONS

See Chapter VII.

CHAPTER III

STATUTORY BENEFITS

INTRODUCTION

Congress has made the determination that certain benefits, called "statutory" benefits, should be offered to all employees regardless of the level of compensation. Congress, however, did *not* prohibit the offering of benefits to some employees and not others, rather Congress constructed an elaborate mechanism which ultimately requires the recipient of the "extra" benefit to pay tax on those benefits which he or she receives that others do not. Complexity is generated by the effort to determine whether the benefits are offered on a discriminatory basis. In this chapter, we will provide definitions essential to making the determinations of discrimination.

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Under this regulatory scheme, employees are divided into two categories: highly compensated employees (HCE's) and non-highly compensated employees (NHCE's). In the case of Section 89 there are four tests, which are laid out in chapter four. Basically, the tests compare the eligibility for, and the benefits received by the HCE's versus the NHCE's. Congress did not require that the benefits be *exactly* equal; rather there are permissible ratios. If the benefit plans fail the tests, the HCE's are taxed on the difference to which the benefits exceed the permissible ratio.

The first steps, then, are to determine if your benefit plan is a "statutory benefit plan" to which the rules apply; determine which of your employees can be excluded from the computations; and, determine which employees are HCE's or NHCE's.

WHAT BENEFITS ARE STATUTORY BENEFITS?

An employer must comply with Section 89's non-discrimination rules if the business offers to its employees:

accidental and health plans

group term life insurance

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At the employer's option, an employer *may* comply if it offers:

education assistance plans

dependent care assistance plans

qualified group legal services plan

The rule does not apply to disability coverage, unless the benefits of such coverage are excludable from gross income for tax purposes.

HIGHLY COMPENSATED EMPLOYEES (HCE)

A highly compensated employee is:

1) a five-percent owner of the business; or

2) an employee who received more that $75,000 in annual compensation; or

3) an employee who received more that $50,000 and is in the top 20 percent of employees by compensation; or

4) an officer of the employer earning $45,000 or more.

An employer, however, may elect to use a simplified method. If the employer maintains significant business operations in at least two significantly separate geographic areas, the employer may simply treat any employee receiving $50,000 or more as an HCE.

Five-percent owners must include any ownership interests of their spouse, children or parents.

Compensation includes wages, bonuses, commissions, tips and so forth. Generally, it is an all encompassing definition with the exception of non-elective employer contributions to pension-type plans.

If an employer has only highly compensated employees, then Section 89's non-discrimination tests do not apply.

PART-TIME EMPLOYEES

Employees who *normally* work less than 17 and one-half hours per week are disregarded in applying the non-discrimination rules. "Normally" is defined as the average number of hours worked during the testing year prior to the testing date. If that period is less than 60 days, the employer must go back to the prior testing year. If an employee did not work 60 days in that prior testing year, the employer looks to hours scheduled to work during the next 60 days or the period of time between the testing date and the end of the testing year. (See Chapter V for the determination of testing date and testing year.)

Scheduled hours determinations are to be made in good faith and are to take into account cyclic-seasonal factors.

A special transition rule permits employers that normally employ fewer than 10 employees to exclude part-time employees who work less than 35 hours in 1989, and 25 hours in 1990.

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EXCLUDABLE EMPLOYEES

The following employees shall be excluded for the purposes of Section 89:

Employees who have not completed one year of service (or in the case of core benefits under a health plan, six months of service).

Part-time employees (see previous section - 17 and one-half hours or less).

Employees who normally work during *not* more than six months during any year.

Employees who have not attained age 21.

Employees covered by a collective bargaining agreement.

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In order for the employer to exclude an individual on any of these grounds, all employees meeting the criteria must be excluded as well. The employer cannot pick and choose.

FORMER EMPLOYEES

In the future, if former employees continue to receive benefits under a plan, they will be included in the calculations for the non-discrimination tests. If they were not employed as of January 1, 1989, however, they may be disregarded for the non-discrimination tests.

CAVEAT: If there is a benefit reduction or increase for former employees, who ended their employment before January 1, 1989, and if the increase or decrease is not uniform for all, the benefits may have to be tested.

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SELF-EMPLOYED

A self-employed individual will be considered an employee for the purposes of the Section 89 tests.

CHAPTER IV

THE TESTS FOR STATUTORY BENEFIT PLANS

INTRODUCTION

The heart of Section 89 is four non-discrimination tests for employee plans. Three of these tests relate to eligibility, the fourth is a benefits test. A key point in administering these test is that even if an employer offers the opportunity to participate to employees on a non-discriminatory basis, the plan may fail the test if the employees choose not to participate.

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PLANS

The definition of what constitutes a plan may be one of the most elusive aspects of Section 89. In 1986, Congress said, "Each different option generally is a separate plan for testing purposes. This means, for example, that if two types of insurance coverage vary in any way (including the amount of required employee contributions), they are considered separate plans." In 1988, Congress amended Section 89 in the Technical Corrections Act, and said, "Each different option is valued separately, but is not considered a separate plan. A plan is a group of options with comparable values (under otherwise applicable comparability rules). With respect to the non-discrimination rules, the effect of these changes is only one of terminology rather than of substance."

Given the new aggregation and comparability rules that are described below, it does appear the outcome will be the same whether the definition of a plan is narrowly or broadly construed.

If two or more plans are identical in all respects except for the group of employees covered, they may treat is as a single plan even if they are governed by separate documents.

If the difference in plans relates only to the number of hours worked, there is a special rule for proportionate reductions and the plans can be treated as a single plan.

In comparing the benefits of a class of employees to the benefits of another class of employees, the employer may be permitted to disregard any ancillary benefits that are required by state law for one of the classes but not for the other.

The significance of these distinctions relates to the application of the various tests described below. In the case of the 90/50 test or the benefits test, all plans of the same type are aggregated. In applying the 50-percent test or the alternative 80-percent test (described later), it is necessary for the plans not only to be of the same type but to be within a certain comparability range. The comparability range is explained below.

LIFE INSURANCE PLANS

Group term life insurance that varies in proportion to compensation will be considered a single plan. Employers may use any non-discriminatory definition of compensation, not only in testing years beginning after December 31, 1990, but also in testing years beginning in 1989 and 1990. A definition of compensation will be considered non-discriminatory for purposes of applying Section 89 to group-term life insurance only if the ratio of (1) the average compensation of the non-highly compensated employees under the definition to (2) the average compensation of the non-highly compensated employees is at least 100 percent of the same ratio for highly compensated employees. Employers also have the option of using base compensation, thereby disregarding bonuses and overtime.

There are two additional exceptions to the general rule that if two types of insurance coverage vary in any way, they are considered separate plans. If, with respect to group-term life insurance coverage, the required employee contributions vary according to the age of the employee, this variation does not preclude treatment of the coverage as a single plan. Thus, for example, if an employer offers every employee group-term life insurance coverage equal to one times compensation, provided that the employee contributes one quarter of the cost of such coverage, this constitutes a single plan even if the cost of each employee's coverage is determined on the basis of such employee's age.

Under the second exception, if, with respect to group-term life insurance coverage, the required employee contributions vary according to the age of the employee, but only up to a specified limit (e.g., the employee's cost may not exceed $X per $1,000 of coverage), this variation does not preclude treatment of the coverage as a single plan. (Under this exception, the employer either may establish a limit up to which age-rating applies fully or may phase the age-rating out gradually.) The use of age brackets of up to five years is permitted under both exceptions. Thus, for example, an employer could establish a series of five-year age brackets and have the required employee contributions only increase when an employee moves from one bracket to another.

If an employer uses the first exception described above, and employee-purchased coverage is not treated as employer-provided, then the amount of employer-provided group-term life insurance coverage with respect to any employee is the amount that bears the same relationship to the total coverage for such employee as the employer's contribution (determined on an age-rated basis) bears to the age-rated cost of such employee's total coverage. For example, if an employee contributes one quarter of the age-rated cost of $100,000 of coverage, and employee-purchased coverage is not treated as employer-provided, the employer-provided group-term life insurance coverage with respect to such employee is $75,000.

If an employer uses the second exception described above and employee-purchased coverage is not treated as employer provided, then the amount of employer-provided group-term life insurance coverage with respect to any employee is determined in the same manner as with respect to the first exception, except that the employer contribution and the total cost of the employee's coverage are calculated on an age-rated basis subject to the specified limit (and to the phase out of age-rating if applicable).

If the employer does not use either of the exceptions described above, and employee-purchased coverage is not treated as employer-provided, the amount of employer-provided group-term life insurance coverage with respect to any employee is determined in the same manner except that the total cost of any employee's coverage and the employer's contributions with respect to such coverage are to be determined without regard to the employee's age.

For purposes of the 90-percent/50-percent test and the 75-percent test, the employer may use the general definition of a group-term life insurance plan or one of the two exceptions despite the fact that the employer did not use the same definition for purposes of applying the 50-percent test to any particular plan.

THE 50-PERCENT TEST

Under the 50-percent test, non-highly compensated employees (NHCE's) must constitute at least 50 percent of the group of employees *eligible* to participate in the plan. (See the general comparability rule only, under the alternative test section for appropriate plan aggregation rules.)

The exception to this rule is when the percentage of HCE's eligible compared to the total of HCE's in the business does not exceed the percentage of NHCE's eligible compared to the total NHCE's in the company. For example, if an employer has 20 employees, 15 of which are HCE's, and *all* employees are eligible for the program, NHCE's constitute only 25 percent of the group eligible to participate, but since all NHCE's (100 percent) are part of the group, the percentage of HCE's (100 percent) does not exceed the NHCE percentage and the 50-percent test is deemed to have been met.

If an employee is eligible for coverage under more than one accident or health plan, then, for purposes of the 50-percent test such plans are required to be considered one plan with respect to such employee. For example, assume that an employer maintains two plans; one benefiting all employees with a value of $950, and a second benefiting only highly compensated employees with a value of $1,000. Highly compensated employees receiving benefits from both plans are to be treated for purposes of the 50-percent test as receiving $1,950 of benefits from one plan while the non-highly compensated employees are to be treated as receiving $950 of benefits from a separate plan.

THE 90-PERCENT / 50-PERCENT TEST

The test simply stated is that at least 90 percent of the employer's NHCE's must be eligible for a benefit that is at least 50 percent as valuable (see Chapter V for valuation rules) as the benefit available to HCE's. Plans of the same type may be aggregate. Benefits paid for by salary reduction arrangements generally may be disregarded when determining the value of available benefits for the purpose of this test. The following example illustrates the 90/50 rule.

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> A firm has 65 employees, 50 NHCE's and 15 HCE's, 45 of the NHCE's are eligible for health plan coverage. Ten of the NHCE's have coverage valued at $1,500, while 20 have coverage valued at $1,000; 5 have $750 worth of coverage; 10 have $500; and 5 are not eligible for any coverage. All of the firm's 15 HCE's are eligible for coverage: 5 have $2,000 in coverage, another 5 have $1,500, and the final 5 have $1,000.
>
> Although 90 percent of the NHCE's are eligible for the plan, it fails the test because only 60 percent of the NHCE's (i.e., those with coverages of $1,500 and $1,000) have a benefit that is at least 50 percent of the largest benefit provided to an HCE (i.e., the $2,000 benefit provided to 5 of the firm's HCE's).

NON-DISCRIMINATION PROVISION

A plan may not contain any provisions relating to eligibility for participation that by its terms or otherwise discriminates in favor of HCE's. For example, if an employer provides unusual coverage for a rare condition to which only the owner of the business is subject, such coverage may fail this test.

BENEFITS TEST

The average employer-provided benefit *actually provided* to NHCE's under all plans of the employer of the *same type* must be at least 75 percent of the average employer-provided benefit actually provided to HCE's. Accidental health plans may be aggregate with other plans to help meet the 75-percent test but *not* the other way around. This is true even if an employer elects to apply the 75-percent test separately to coverage of employees and coverage of employee's spouses and dependents. The average is calculated by dividing the aggregate benefits received by the employees in question, HCE's or NHCE's, by the total number of HCE's or NHCE's in the business whether or not they are covered by such plans.

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$$.75 \quad \times \quad \frac{\text{HCE's benefits}}{\text{Total of HCE's}} \quad \leq \quad \frac{\text{NHCE's benefits}}{\text{Total of NHCE's}}$$

Generally, "benefit" means the value of plan coverage not the actual services or reimbursements provided under the coverage. The following example illustrates the benefit test.

A firm has 60 employees, 50 are NHCE's and 10 are HCE's, and a health plan. Of the 50 NHCE's 30 have coverage valued at $1,000; 15 have coverage valued at $1,500; and 5 have coverage worth $500. Thus, the average benefit provided to the NHCE's is $1,100 (i.e., $30,000 + $22,500 + $2,500 = $55,000; $55,000 ÷ 50 = $1,100).

The firm also has 10 HCE's; 5 of these highly paid workers receive $1,500 in coverage, while the other 5 receive $2,000. The HCEs' average benefit amounts to $1,750 ($7,500 + $10,000 = $17,500; $17,500 ÷ 10 = $1,750).

To satisfy the 75 percent test, the average benefit provided to NHCE's must be at least 75 percent of the benefit provided to HCE's. Based on an average benefit of $1,100 for NHCE's, the allowable benefit for HCE's is $1,467 ($1,100 ÷ 0.75 = $1,467). However, since the actual average employer-provided benefit for the HCE's is $1,750, the plan fails the test because the HCE's benefit exceeds the allowable limit.

ALTERNATIVE TEST

Congress did create a safe harbor for meeting the 90/50, 50, and benefits tests by creating a single alternative test. If the employer can show that at least 80 percent of all NHCE's receive the benefit (*are actually covered by the plan*) then the plan will be considered as having met the tests. Eligibility to receive coverage is not considered benefitting under the plan. There are, of course, some rules for conducting this test, much of which relates to comparing plans. The employer cannot automatically aggregate plans of the same type.

1) **General Comparability Range - For purposes of the 80-percent test, a group of plans are comparable and may be aggregated if the value of the employer-provided coverage provided to each covered employee in the plan with the lowest such value is *at least 90 percent* of the value of the employer-provided coverage provided to each covered employee in the plan with the highest such value. The comparability standard is *reduced to 80 percent* if the employer elects to apply the 80-percent test as a 90-percent test.**

2) **Plans Outside the General Comparability Range** - For purposes of the 80-percent test, a plan with a value greater than that permitted under the general comparability rule may be aggregated with a group of less valuable comparable plans if the employees covered under the plan with the greater value is at least 80 percent (90 percent if the 80-percent test is applied as a 90-percent test) of the percentage of highly compensated employees covered under such plan.

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3) **Comparability Safe Harbor** -

   a) Under the general safe harbor rule for purposes of the 80-percent test, a group of plans is treated as comparable with respect to a group of employees if:

      (i) such plans are available on the same terms to all employees within the group, and

      (ii) the difference in annual cost to the employees between the plan in the group with the smallest employee cost and the plan with the highest employee cost is not more than $100.

   b) Any other plan may be aggregated with the group of plans in (a) if such other plan is comparable under the general comparability range to the plan within the group with the largest employer-provided benefit.

   c) A plan may also be treated as comparable to the group of plans described with respect to an employee if:

      (i) in the case of a non-highly compensated employee, such employee is eligible under the plan within the group with the largest employer-provided benefit

      (ii) in the case of a non-highly compensated employee, the employee contribution permitted with respect to the group of plans under the general safe harbor, and

      (iii) the employer-provided benefit under the plan outside the group is less than the employer-provide benefit under the plan within the group with the largest such benefit (without taking into account any plans aggregated under (b) above).

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FAMILY COVERAGE AND COVERAGE ELSEWHERE

For purposes of determining whether the requirements of the 75 percent benefit test or the alternative are met with respect to health plans, the employer may elect to disregard any employee if such employee and his spouse and dependents (if any) are covered by health plan providing core benefits maintained by another employer; and, to apply either test separately with respect to coverage of spouses or dependents by such plans and to take into account with respect to such coverage only employees with a spouse or dependents who are not covered by a health plan providing core benefits maintained by another employer. However, the 80 percent test must still be met without regard to the above elections.

A sworn statement by the employee is required in such case (*see Chapter V for sworn statement requirements*).

In the case of a HCE who receives employer-provided benefits under all health plans of the employer which are more than 133 and one-third percent of the average employer-provided benefit under such plan for NHCE's, the employer may not disregard such employee, or his spouse or dependents for purposes of the above elections. Employers may not disregard any employee based on the receipt of other core health coverage unless the employee has the right to elect and receive health coverage from the employer as if it were open season in the event that the other coverage ends.

The term "core benefits" has not been defined. The only clue to date are legislative history references to items that are ***not*** **benefits, such as:**

dental
vision
psychological
orthodontia
elective cosmetic surgery

If an employee would otherwise be entitled to coverage of his or her spouse or dependent(s) under the terms of an accident or health plan, such employee is considered to receive such coverage despite the fact that such employee may not have a spouse or dependent(s). Thus, for example, if coverage of an employee's spouse and dependent(s) is *non-contributory* and the employee does not reject the coverage, such employee is considered to receive coverage of his or her spouse and dependent(s) without regard to whether he or she has a spouse or dependent(s). If coverage of an employee's spouse and dependent(s) is *contributory* and the employee makes the required contribution, such employee is considered to receive coverage for his or her spouse and dependent(s) without regard to whether he or she has a spouse or dependent(s). Of course, in such case, if the employee does not make the required contribution, the employee is not considered to receive coverage for his or her spouse and dependent(s) (if any).

CHAPTER V

COMPLIANCE

TIME FOR TESTING

Testing Year

An employer may choose a common testing year for all its plans. It may or may not coincide with the plan year. If the employer does not designate a testing year, then the testing year is the calendar year.

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Testing Date

An employer may choose any day as the testing date however the date must be used consistently. If a testing date is not designated then it shall be the last day of the testing year.

Changes

Changes of the testing year or testing date can only be made with the consent of the IRS. Consistency is the key.

Sampling

Rather than demonstrate compliance based on data with respect to all employees, an employer may use a sample. It must be a statistically valid sample. A sample is valid if the statistical method and sample size produce a 95-percent level of confidence that the sample results have a margin of error not greater than 3 percent. If the sample suggests the plans are discriminatory, complete data on the highly compensated employees (HCE) must be collected and the discrimination tests applied again. The sample can still be used for the NHCE's.

Sworn Statements

If the issue is coverage elsewhere, the employer is required to document that fact and the nature of the coverage with a sworn statement. These sworn statements should be updated every three years. The employer may collect sworn statements or use a statically valid sample of the employees.

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Valuation

Valuation of the benefits and coverage are perhaps the most difficult element of the Section 89 process. Eventually the IRS is to establish a table prescribing the relative values of different types of health coverage.

The effective date of these rules, when published, will be either the first testing year beginning at least one year after issuance of the rules or the first testing year beginning after December 31, 1990, whichever is later. In the interim, the value may be the value of the coverage for health and group life insurance.

For the purposes of the eligibility and benefit safe harbor tests, the employer may use any reasonable method to determine value.

Pursuant to the temporary special valuation rule, the value of an accident or health plan may, for purposes of determining if a plan is discriminatory, be calculated under any actuarially reasonable valuation method adopted by the employer. In addition, an employer may, under a reasonable valuation method, use the cost of accident or health coverage as the value of such coverage. In such cases, the cost is to be determined in the same manner that the employer determines the applicable premium for purposes of the health care continuation rules (required by Section 162(k) of the tax code). Cost may be determined in advance based on estimates. This does not mean, however, that the entire cost of accident or health coverage is to be used as the value of the employer-provided benefit. It is only the employer's share of such cost that may be used as the value of the employer-provided benefit.

To facilitate planning, an employer may use, as the cost of accident or health coverage for a testing year, the average annual cost or substantially similar coverage provided during the immediately preceding one or two years.

The employer also may make reasonable adjustments to the cost of coverages to eliminate cost differences between the coverages attributable to (1) differences in the cost of accident or health coverage in different geographic areas, and (2) the demographic characteristics of the covered employees. For example, assume that the employer provides individual coverage to employees in State X that costs $1,000 per employee, but that would cost $1,200 per employee in State Y. Assume further that the employer also operates in State Y and tests its State X employees with its State Y employees under Section 89. In such case, the employer may, for example, treat the individual coverage provided in State X as costing $1,200 for purposes of testing such coverage with the coverage provided in State Y.

Another example of a permissible adjustment under the above rule would be an age-related adjustment. For example, assume that the employer provides individual coverage to a group of young employees that costs $800 per employee, but if provided to a group of the employer's older employees would cost $1,100. In such a case, the employer may treat the individual coverage provided to the young employees as costing $1,100 for purposes of testing such coverage with the coverage of the older employees.

The employer may also adjust its cost to eliminate differences in costs between coverages that are attributable to differences in utilization of certain health care features that are common to the different coverages. For example, if all of an employer's cancer cases arise under a specific health plan and the cancer-relevant health features of such plan are common to other health plans, the costs of such plans may be adjusted to eliminate this utilization distortion. This adjustment is to be made after the adjustments described above and is to be made by estimating the cost of all plans that are tested together and that have the common feature as if the utilization had been evenly distributed among the plans. If this adjustment is made with respect to one health care feature common to a group of plans, it must be made with respect to all features common to such group of plans.

If an employer does not use cost as its valuation method, a valuation method will not be considered unreasonable solely because it does not take into account every feature of every accident or health plan provided by the employer. It may be reasonable to disregard a very limited number of features that have little effect on value, but are burdensome to value precisely. However, if any feature has significant value or is made available to a highly disproportionate number of highly compensated employees, such feature may not be disregarded under a reasonable valuation method. An example of a feature that has significant value and typically is made available to a highly disproportionate number of highly compensated employees is an annual physical examination.

All of an employer's accident or health plans that are tested together under Section 89 are to be valued under the same actuarially reasonable valuation method. Thus, if an employer uses cost as its evaluation method and adjusts cost under one or more of the rules described above, the employer must use cost and make the same adjustments to all plans tested together under Section 89.

This rule, requiring an employer to use the same valuation method for all of its plans, means that, for example, two health plans with identical costs (if cost is used) or coverages (if a non-cost valuation method is used) may not be assigned different values merely because one is a health maintenance organization and one is an indemnity plan.

Similarly, the same valuation method should be used for valuing, for example, dental plans, hearing care plans, vision plans, physical examination plans, substance abuse programs, etc.

In order to determine if accident and health coverages are discriminatory, two steps are necessary. First, the total value of all accident and health coverage must be determined. The second step is determining the portions of such coverage that are employer-provided. This determination is to be based on the actual cost of the coverage, determined in the same manner that the employer determines the applicable premium for purposes of the health care continuation rules. Cost may be adjusted for this purpose for differences in utilization in the manner described above. However, none of the other adjustments described above is permitted.

Assume that the actual cost of health coverage provided to an employee is $1,600 and the employee contributes $400 of this amount. The employer-provided health coverage is 75 percent of the total coverage received by the employee. If the employer uses the same actual cost for testing purposes, the employer-provided coverage will have a value of $1,200, rather than $1,600, the employer-provided portion for testing purposes is 75 percent of $1,200 or $900.

CHAPTER VI

LINE OF BUSINESS, MULTI-EMPLOYER PLANS, CAFETERIA STYLE PLANS

LINE OF BUSINESS

An employer may apply Section 89 rules to each separate line of business or operating unit.

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A bona fide line of business or operating unit will not be treated as separate unless:

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1) **the line of business has at least 50 employees;**
2) **the employer notifies the IRS; and,**
3) **the highly compensated employee percentage with respect to such line of business is:**
    (i) **not less than one-half, and**
    (ii) **not more than twice the percentage which highly compensated employees are of all employees of the employer. An employer shall be treated as meeting the requirements of clause (i) if at least 10 percent of all highly compensated employees of the employer perform services solely for such line of business.**

These requirements shall be treated as met with respect to any line of business if such requirements were met with respect to such line of business for the preceding year and if:

(i) **no more than a de minimis number of employees were shifted to or from the line of business after the close of the preceding year, or**

(ii) **the employees shifted to or from the line of business after the close of the preceding year contained a substantially proportional number of highly compensated employees.**

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Separate operating units must be at least 35 miles apart. A line of business or operating unit includes all employees necessary for the preparation of property for sale to customers or for the provision of services to customers. Thus, a headquarters or home office is not to be treated as a separate line of business or operating unit. Certain exceptions to the general rule (but not to its application to headquarters or home offices) may be established by regulation where an employer has two operations that are vertically integrated and that traditionally are operated by unrelated entities.

In addition, whether claimed lines of business or operating units are separate and bona fide is a facts and circumstances determination requiring examination of each particular situation. Differences and similarities between the services provided and products produced by such claimed lines of business or operating units are, of course, important considerations. Also, the manner in which the employer organizes itself is relevant. Thus, if an employer fails to treat itself as comprised of separate lines of business or operating units in an equivalent fashion for certain purposes, such as for coverage under an employer-wide qualified plan, it may not be appropriate to allow such activities to be treated as separate lines of business or operating units.

Notwithstanding the general rules described above, the line of business or operating unit concept is not to be used to undermine the non-discrimination rules. Thus, for example, certain job classifications (such as hourly employees or leased employees) are not to be treated as in a line of business or operating unit. Also, for example, secretaries and other support service personnel are not to be treated as in a line of business or operating unit separate from the lawyers, other professionals, or other employees for whom such personnel perform services. Likewise, nurses and laboratory personnel are not to be treated as in a line of business or operating unit separate from the medical doctors for whom they perform services.

MULTI-EMPLOYER PLANS

Section 89 addresses the subject of multi-employer plans with a series of special rules and exceptions. An employer using a multi-employer plan should consult with an expert.

Examples of the special rules include:

1) **An employer contributing to a multi-employer plan is entitled to use a special method for determining excludable employees only if that employer does not contribute to the plan on behalf of an employee who performs professional services. Thus, the determination of eligibility for the special method is applied on a contributing employer by contributing employer basis. For purposes of this provision, professional services include the following services: legal, medical, engineering, architecture, actuarial science, financial, consulting, accounting, and such other services as the Secretary shall determine.**

2) **An employer may treat the contribution such employer makes to a multi-employer plan on behalf of an employee as the employer-provided benefit of such employee under such plan if:**

The allocation of plan benefits between highly compensated employees and other employees under a multi-employer plan (or within either of such groups) varies materially from the allocation of employer contributions to such plan, or the employer contributions relate to benefits of different types.

This does not apply to any employer maintaining a multi-employer plan if such employer makes contributions to such plan on behalf of any individual performing services in the field of health, law, engineering, architecture, accounting, actuarial science, financial services, or consulting.

3) **The IRS will allocate the reporting responsibility with respect to plans between the individual employers and multi-employer plan based on the agreement between the parties.**

CAFETERIA PLANS

For most purposes of Section 89, cafeteria plans (basically, an employee chooses benefits from a "menu" of options) are tested the same as any other plan. For the purposes of satisfying the 90/50 test and the proportionate reduction for part-time employees, benefits paid for by a salary reduction agreement are treated as provided by the employee, not the employer.

Elective contributions under a plan may be taken into account in satisfying the 90/50 test if:

(1) **the percentage of non-highly compensated employees eligible under the plan is not greater than the same percentage of highly compensated employees;**

(2) **all eligible employees are eligible under the same terms and conditions;**

(3) **no eligible highly compensated employee is also eligible for any benefit of the same type that is not equally available to every eligible non-highly compensated employee; and**

(4) **all salary reduction amounts are taken into account with respect to any employee.**

Employers who maintain cafeteria plans may limit the elections made by highly compensated employees in a non-discretionary manner. An employer is prohibited from applying the limitations on elective contributions based on utilization of elective amounts or based on any other system that has the effect of avoiding the cafeteria plan rule that elective contributions not used during a year are forfeited.

For purposes of applying the cafeteria plan non-discrimination rules, an employer may exclude a category of employees from consideration only if all employees in such category are excluded with respect to all options offered by the cafeteria plan.

In the case of a cafeteria plan that fails the cafeteria plan non-discrimination test only highly compensated employees are required to include the available taxable benefits in income. In the case of a cafeteria plan that fails the employee concentration test, only key employees are required to include the available taxable benefits in income.

The qualified cafeteria benefits include benefits that would be qualified benefits but for the fact that they are includible in an employee's income because of a failure to satisfy the non-discrimination requirements. Thus, if, for example, there is a discriminatory excess with respect to a health plan offered under a cafeteria plan, such discriminatory excess will not cause the cafeteria plan to cease to be a cafeteria plan.

CHAPTER VII

SANCTIONS

QUALIFICATION REQUIREMENTS

If an employer fails to comply with the qualification requirements for *any* benefit whether statutory or other, as outlined in Chapter 2:

The benefit must be included in the gross income of any employee that receives the benefit.

The amount includible is the value of the *benefits* not the coverage attributable to contributions made by the employer. In the case of statutory benefits failing the non-discrimination tests (*see Chapter IV*) coordination of income includible must be coordinated.

The amount is includible in the taxable year in which benefits are received.

The employer tax penalty is equal to the highest individual tax rate multiplied by the employee's employer-provided benefit.

STATUTORY BENEFITS

Discriminatory Excess

In the case of statutory benefits, if the plan is determined to be discriminatory in favor of HCE's, the discriminatory excess must be includible in the gross income of the employee.

Discriminatory excess is the amount of the otherwise non-taxable employer-provided benefit that the highly compensated individual would have had to purchase on his or her own so that all the non-discriminatory tests under Section 89 would have been met. Special rules apply for group term life insurance.

In order to determine the discriminatory excess, the 50-percent test is applied first, the 90/50 test second, and then the benefits test. Alternatively, the excess may be computed on the basis of the 80-percent test. Congress offered the following example to determine the discriminatory excess.

Assume that an employer uses the calendar year as its testing year and January 1 as its testing date. Assume further that all of the employer's accident and health plans satisfy the 50-percent test, the 90-percent, and the non-discriminatory provision test. Assume that the employer elects to test employee coverage and coverage of spouses and dependents together for purposes of the 75-percent test.

Example 1 - Assume that for 1990, the following facts exist:

DETERMINATION OF DISCRIMINATORY EXCESS

Employee	Employment during 1990	Employer provided benefit	Testing value
A	1/1-6/30	$ 500	$1,000
B	1/1-12/31	1,000	1,000
C	1/1-12/31	1,500	1,500
D	2/1-12/31	1,375	N/A
E (highly compensated)	1/1-6/30	900	1,800
F (highly compensated)	1/1-12/31	1,800	1,800
G (highly compensated)	2/1-12/31	917	N/A

Assume further that there are no changes in plan design or changes in highly compensated employees' elections during 1990.

The employer-provided benefit column provides the actual employer-provided benefits received by each employee during 1990. The testing value column provides the annual value of the employer-provided benefit that each employee receives on the testing date. This testing value is determined by taking into account the actual employer-provided benefit for each employee who is employed on the testing date, but adjusting such benefit to the value of the benefit as if it were provided for the entire testing year. It is this value that is used for purposes of applying the 75-percent test. There are no testing values for D and G because they are not employed on the testing date and thus are disregarded for testing purposes.

Based on these facts, for purposes of the 75-percent benefits test, the average employer-provided benefit for the non-highly compensated employees is $1,167 [($1,000 + $1,000 + $1,500)/3]. The average employer-provided benefit for the highly compensated employees is $1,800 [($1,800 +$1,800)/2]. In order to satisfy the 75-percent test, the average employer-provided benefit may not exceed $1,556 ($1,167 /.75). Thus, there is a discriminatory excess under the 75-percent test.

Once an employer determines that there is a discriminatory excess under the plan, the employer is required to determine the actual employer-provided benefit for every highly compensated employee, including those not employed on the testing date, and apply the tests based on such data. This calculation may result in an increase or decrease or even an elimination of the discriminatory excess. The average employer-provided benefit for non-highly compensated employees is not recalculated.

For example, under the above facts, the average employer-provided benefit for the highly compensated employees is $1,497. This is determined under the present-law rules applicable for purposes of the 75-percent test (i.e., by including the actual employer-provided benefit in the numerator and counting an employee as less than a full employee in the denominator if such employee is not employed for the entire year). In this example, E is 1/2 of an employee and G is 11/12 of an employee. Thus, the average employer-provided benefit for the highly compensated employees is calculated as follows: ($900 + $1,800 + $917) /(1 + 1/2 + 11/12) = $1,497. Because $1,497 is less than $1,556, there is no discriminatory excess under the 75-percent test.

Assume, however, that G's actual employer-provided benefit is $1,650, rather than $917. In this case, the average employer-provided benefit (based on actual data) for the highly compensated employees is $1,800. This amount is calculated as follows: ($900 + $1,800 + $1,650) / (1 + 1/2 + 11/12) = $1,800. Because $1,800 is above the maximum permitted average for the highly compensated employees of $1,556, there is a discriminatory excess, and it is necessary to allocate the excess among the highly compensated employees.

The amount of the discriminatory excess is determined and allocated as follows. First, the total discriminatory excess for all highly compensated employees is determined by (1) calculating what the total employer-provided benefit for all highly compensated employees would be if the average employer-provided benefit for such employees satisfying the benefits test, and then (2) subtracting the amount in (1) from the total actual employer-provided benefit for all highly compensated employees.

In the example, the calculation of the total permitted employer-provided benefit for highly compensated employees is $1,556 x (1 + 1/2 + 11/12) = $3,760. Then this amount is subtracted from the actual employer-provided benefit for the highly compensated employees to obtain the total excess of $590 as follows: ($900 + $1,800 + $1,600) - $3,760 = $590.

To allocate the $590 of discriminatory excess among the highly compensated employees, F's benefit is reduced first, because F has the highest employer provided benefit. Thus, F's other wise nontaxable employer-provided benefit is reduced by $150, to the level of G's employer-provided benefit. Then, F's and G's benefits are reduced equally until the remaining $440 of excess ($590 - $150) is allocated. That is F's benefit is reduced by an additional $220. Thus, F's total nontaxable benefit is $1,430 ($1,800 - $150 - $220), as is G's ($1,650 - $220). A total of $370 ($150 + $220) is includible in F's income, and a total of $220 is includible in G's income.

The benefit is includible in income in the employee's taxable year in which, or with which, the plan year ends, but if the testing year ends after September 30, and on or before December 31, an employer can elect to include it in the employee's next taxable year but the employer must take the deduction for that amount in its taxable year that follows the taxable year in which the testing year ended.

Employer Sanction

The employer must pay a penalty tax for failure to report the excess equal to the product of the highest individual tax rate times the portion of the employee's benefit that bears the same relationship to the total benefit as the unreported amount bears to the entire amount that should have been reported.

NATIONAL SMALL BUSINESS UNITED

"Serving America's small businesses since 1937"

BEFORE THE COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES
THE HONORABLE JOHN J. LaFALCE, CHAIRMAN

TESTIMONY OF
JAMES H. LAGOS, PRESIDENT
NATIONAL SMALL BUSINESS UNITED

IN SUPPORT OF THE REPEAL OF SECTION 89
OF THE INTERNAL REVENUE CODE OF 1986
JANUARY 24, 1989

JAMES H. LAGOS.
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Mr. Chairman and Members of the Committee:

I wish to begin by expressing my own personal appreciation and the appreciation of the 50,000 small businesses represented by National Small Business United to you for holding these hearings. You are providing us our first opportunity to address a Congressional Committee concerning the problems that Section 89 of the Internal Revenue Code of 1986 has caused for the American small business community. National Small Business United is the oldest association now serving the small business community of our nation. National Small Business United represents small businesses in all 50 states as well as local, state and regional organizations and one national trade association. The organization is run essentially by volunteers such as myself who leave their small businesses and come to Washington entirely at their own expense to participate in the political process.

I myself have spent approximately 14 years as a small business advocate at the local, state and national levels. My brother and I have a small law firm in Springfield, Ohio, sometimes representing small businesses and sometimes representing employees. We are also engaged as principals in various small businesses, including industrial contracting, farming, and a variety of real estate projects. My family has been engaged in a number of small business endeavors throughout the years. I can safely say that I have had personal contact with just about every type of small business problem that you can imagine.

Section 89 of the Internal Revenue Code of 1986 is a perfect example of a law that was passed with the best of intentions but which will have devastating effects on the small business community of this country. The law itself was designed to eliminate discrimination in health and life insurance programs provided by employers. Unfortunately Section 89 will have exactly the opposite effect. Section 89 will cause many employees to lose their existing health insurance and prevent many from obtaining it in the first place. In order to understand why this is so, it is necessary to look at the exact language of the statute. I will begin with the tail end of Section 89 first.

Section 89 (k)(1) of the Internal Revenue Code of 1986 provides in part as follows:

[G]ross income of an employee shall include an amount equal to such employee's employer-provided benefit for the taxable year under an employee benefit plan to which this subsection applies unless, except to the extent provided in regulations -

(A) such plan is in writing,
(B) the employees' rights under such plan are legally enforceable,
(C) employees are provided reasonable notification of benefits available in the plan,
(D) such plan is maintained for the exclusive benefit of employees, and
(E) such plan was established with the intention of being maintained for an indefinite period of time.

This subsection goes on to state that it applies to any "statutory employee benefit plan" or qualified tuition reduction program" or "cafeteria plan" or "employee discounts" or "employee operated eating facilities". "A statutory employee benefit plan" is defined in another subsection to mean all health and life insurance programs. If the employer elects, it can include other benefits such as a day care program or a legal services program. These will not be covered unless an employer elects to have them covered, and I do not see any reason as to why an employer ever would. Any benefits received by an employee under this subsection would require that the amount of these benefits be listed on his or her W2 Form. An employer would be given substantial penalties if he fails to report these benefits on the employee's W2 Form. The employer's penalty is rather difficult to calculate, but if the benefits obtained by an employee under this subsection equal half of the benefits that would have been required to be reported by the employer then the employer would be given a penalty equal to that amount.

This all seems rather esoteric, but it can have a savage result. Let us assume that an employer fails to conform to this subsection simply because he has never heard of it. I believe that it is safe to assume that 99% of the owners of small businesses in the United States of America have never heard of Section 89. Nonetheless, the vast majority of them are already subject to its provisions. This is because of the operation of subtitle C Section 3021 (c)(3) of the Technical and Miscellaneous Revenue Act of 1988. This obscure section provides that employers with employee health or life insurance plans had to provide their employees with reasonable notice of their plans essential features on or before the beginning of the fiscal year of their plans. For most small businesses this means the beginning of the calendar year. The calendar year in question happens to be 1989. The deadline was December 31, 1988. Thus, most small businesses are already in violation of Section 89 (k)(1).

Let us assume that an employee named John Smith works for a small business named ABC Inc. ABC Inc. has both employee health and life insurance plans. Assume John Smith develops heart problems and runs up $100,000.00 in medical expenses. This employee, as well as his employer, never heard of Section 89. Low and behold it now becomes necessary for John Smith to pay $28,000.00 of federal income taxes on his benefits. Moreover ABC Inc. is subject to a penalty if it does not report this fact on John Smith's W2 Form at the end of this year. If the "total benefits" of all the employees of ABC Inc. equal the sum of $200,000.00 then ABC Inc. will be taxed on $100,000.00 of ordinary income. This will be true even if the premium ABC Inc. paid for John Smith's health insurance amounted to only $1,500.00 to $2,000.00.

That's not all. Let us assume that John Smith died as a result of his heart problems. His widow, Mary Smith, was able to receive life insurance benefits from the group life program offered by

ABC Inc. This life insurance benefit was in the amount of $100,000.00. Low and behold, Mary Smith now finds out that she owes the Internal Revenue Service some $28,000.00 on the proceeds of the life insurance policy because ABC Inc. violated Section 89 (k)(1). Again, ABC Inc. may be subject to a similar penalty.

The scenario can even get worse. Let us assume that ABC Inc. in fact complied with Section 89 (k)(1). If ABC Inc. was part of a larger "controlled group" of small businesses owned by the same people, then it is quite possible that the horrible results demonstrated above could take place if any one of the controlled group companies was not in compliance.

This is only a small part of Section 89. It is one of the simplest parts of its' operation. Section 89 really gets complicated when it starts talking about the eligibility requirements and benefits requirements. A key phrase of Section 89 is "discriminatory employee benefit plan". The main purpose of Section 89 is to tax the benefits of "highly compensated employees" who receive benefits which are discriminatory as compared to other employees. For the plan not to be taxable as ordinary income to the recipient, both the eligibility requirments and the benefit requirements must be met. Eligibility requirements which are found in Section 89 (d) are as follows:

(d) ELIGIBILITY REQUIREMENTS -

(1) IN GENERAL. - A plan meets the eligibility requirements of this subsection for any testing year if -

(A) at least 90 percent of all employees who are not highly compensated employees -

(i) are eligible to participate in such plan (or in any other plan of the employer of the same type), and

(ii) would (if they participated) have available under such plans an employer-provided benefit which is at least 50 percent of the largest employer-provided benefit available under all such plans of the employer to any highly compensated employee,

(B) at least 50 percent of the employees eligible to participate in such plan are not highly compensated employees, and

(C) such plan does not contain any provision relating to eligibility to participate which (by its terms or otherwise) discriminates in favor of highly compensated employees.

It is not enough to meet only one of these three tests, all three of the tests must be met.

The benefit requirements are found in Section 89 (e). They are as follows:

(e) BENEFIT REQUIREMENTS-

(1) IN GENERAL. - A plan meets the benefit requirements of this subsection for any testing year if the average employer-provided benefit received by employees other than highly compensated employees under all plans of the employer of the same type is at lease 75 percent of the average employer-provided benefit received by highly compensated employees under all plans of the employer of the same type.

The Benefit Requirements do not appear to be too complicated, but this is deceptive. There are any number of tests that one has to go through in order to determine the "average employer provided benefit".

There is an apparent exception in the above requirements. If a plan actually covers 80% of the employees who are not highly compensated employees then the above requirements are waived. It only applies if 80% of the employees are actually covered and not simply eligible for coverage. There is however, a "catch 22" in this apparent exemption. This exemption specifically states that it does not apply unless subsection (d)(1)(c) is met. This, as is mentioned above, states that the plan must not discriminate in eligibility between highly compensated and non-highly compensated employees. There is no other place in Section 89 that defines discrimination except subsection (c). This subsection describes a discriminatory employee benefit plan as any plan that does not meet both sections (d) and (e) which are quoted above. Therefore, it is arguable that every plan has to meet the eligibility requirements of subsection (d) and the benefits requirements of subsection (e). If this is true then there is no exception.

Please note that we have not covered many of the other complexities of Section 89 including such esoteric subjects as which employees are covered by what groups, the gathering of data on the plans and the testing process. Suffice it to say that Section 89 is extremely complicated. This brings me to my major point. I, as an attorney representing small businesses will be called upon by them to pass judgment on whether or not their particular life or health insurance plans pass muster under Section 89. This will be a problem faced by many attorneys, CPA's and advisors of small businesses across the country. The safest thing for me as an attorney to tell my clients is that it would be best for those employers to terminate their health and life insurance plans and simply tell their employees to buy these plans on their own. To advise clients in these complex matters is like walking in a mine field.

The employers who do continue to maintain their health insurance programs will have to spend substantial sums of money in testing these programs to see if they pass muster under Section 89. They will always have the fear that they will not pass muster and that they themselves and their employees will be subjected to enormous penalties by the Internal Revenue Service. There is a tremendous disincentive created by Section 89 for employers having health and life insurance programs for their employees. This is most ironic. We saw in the last Congress an attempt to mandate health insurance requirements upon all employers. We now see with Section 89 a tremendous disincentive for employers to have employee health insurance programs.

Small businesses will have their competitive capabilities vis a vis large businesses reduced by Section 89. Large businesses have experts on staff to take care of regulatory burdens like Section 89. Small business will have to hire outside consultants. Small businesses will be increasingly unable to compete for a shrinking pool of workers with large businesses.

Prior to coming here today, I consulted any number of small business people concerning their opinions of Section 89. These opinions include the following:

1. "drain on productivity"
2. "uncertainty"
3. "frustration"
4. "just ridiculous"
5. " overwhelming"
6. "what is this mess?"
7. "very difficult for small business"
8. "contrary to congress' desire to expand health care coverage"
9. "no guidance"
10. "really scary"
11. "extremely large record keeping documentation burden"
12. "it's going to increase my costs and hurt my employees"
13. "we're leaning toward terminating our plan"
14. "I think that's the craziest thing"

One CPA told me he had had a marked increase in what he referred to as "oh my God calls". My friend, Carol Ball, who owns the Ball Publishing Company in Greenville, Ohio responded to my questions in this manner. She said "Even to prove my innocence will cost me a couple of thousand dollars". She added that she was probably being conservative, and I think that she was right. The cost to each individual small business with a health insurance program to qualify under Section 89 to make sure that they are not getting into serious trouble will be exceedingly high. Even a two man shop will have to go through the formalities of a written plan in order to comply with Section 89. Small businesses will have to try to figure out the rules and then apply them. They will have to go through a lengthy testing program to see if their programs qualify under Section 89. The same rules will be applied for small businesses as are applied to large businesses. This will be, as another CPA told me, "awfully tough on small businesses".

Mr. Chairman and members of the committee, I respectfully submit to you that if Section 89 is not immediately repealed that there will be a stampede of small businesses canceling their life and health insurance programs. Section 89 is basically an ambush waiting to happen. It is an ambush of innocent and well meaning small business owners and their employees who will be subjected to enormous penalties from a law they do not even know exists. Frequently when discussing small business regulations we speak in terms of exemptions of small businesses below an employment level or exemptions in threshold levels before a particular law will apply. I frankly do not believe that this would be appropriate in the case of Section 89. Regardless of these exemptions, many many small business people would be very adversely affected by Section 89.

Mr. Chairman, I thank you and the members of the committee for holding these hearings. You have provided a vital service to the small business community. I encourage you to work as hard as possible for the immediate repeal of Section 89 of the Internal Revenue Code of 1986. I pledge to you that we the members of National Small Business United will be fighting side by side with you in this important battle. Thank you all very much.

NATIONAL SMALL BUSINESS UNITED

"Serving America's small businesses since 1937"

Statement of

John Paul Galles
Executive Vice President,
National Small Business United

Before the
House Committee on Small Business

Concerning
Section 89
of the Internal Revenue Code

January 24, 1989

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TESTIMONY FOR THE REPEAL OF SECTION 89

Before the U.S. House Committee on Small Business

January 24, 1989

By John Paul Galles

Executive Vice President, National Small Business United

I would like to begin by thanking the House Committee on Small Business for inviting me to testify on behalf of National Small Business United (NSBU), regarding Section 89 of the Internal Revenue Code. I am very pleased to have the opportunity to testify on such an important issue as Section 89.

As you may well know, NSBU is the oldest association exclusively serving the small business community of our nation now for over 50 years. NSBU has a membership of over 50,000 individual companies with members in each of the 50 states, as well as local, state and regional organizations. Obviously, NSBU is uniquely qualified to express the views of the independent business person.

On behalf of these people, we urge the House to repeal Section 89. Section 89, of course, was passed as part of the Tax Reform Act of 1986, an Act which has already complicated the lives of small business owners and cost them a great deal of money.

Specifically, Section 89 addresses the discrimination of employer-based fringe benefit plans. Its goal was to extend these plans to all employees. Section 89, however, may result in accomplishing just the opposite; it may, in fact, eliminate benefits to many employees.

Unfortunately, the cost of health benefits is not borne equally by all employers. Small Business pays a disproportionately higher cost for benefits than does Big Business. This is the result of economies of scale. In addition, Small Business is often unable to afford the same level of benefits for all employees, but will frequently use a more attractive package to attract a more talented and experienced workforce. Section 89 will force the end of this practice and hamper the ability of small businesses to compete for high quality employees.

An example of the decrease in health benefits caused by Section 89 comes from a company in Milwaukee, Wisconsin, which makes seats for aircraft and employs 146 people. The owner of this firm had previously contributed 100 percent for health benefits. Instead of paying to figure out if he complied, he dropped all coverage. In his words, "No coverage assures no discrimination." Similarly, an insurance agency in Auburn, California, with 28 employees had plans to extend its coverage, but now has cancelled all of its policies.

The main reason for eliminating coverage is cost. The fact is that the administrative requirements, in themselves, far exceed the capabilities of many small business employers. First of all, the law requires that all benefit plans be in writing even with firms with fewer than 10 employees and all employees must be notified of the benefits available in those plans. Also, the written plans must inform employees that their rights under such plans are legally enforceable.

Second, the employer will need to gather and evaluate information on their current health plans. This will cause a real need for outside expertise which will greatly increase costs. Before testing begins, employers must:

* identify the company's total number of plans
* determine each plan's value
* identify the employees participation in each plan, and
* classify employees into three groups: highly compensated, not highly compensated and those who do not have to be included in tests.

The definition of a "plan", as defined in Section 89, is very narrow. If two plans differ in any way (ie. single and family coverage or a plan with two deductibles), each must be treated separately. As an example, a businessperson from California who has 150 employees originally had only five plans, but under Section 89 now qualifies as 17 different plans. As you can see, even before testing begins, employers lose precious time and money.

Finally, the employer is now ready to apply the discrimination tests. Unfortunately, this is where the process really gets complex. Attempts to comply have been called "an administrative migraine" and "an absolute nightmare" by business owners. Businesses with more complex benefits will have to use a four-step testing method. According to the statute, Section 89 is not concerned with the "opportunity" to participate in benefit plans, but the "actual" rates of participation. Employers will be penalized if employees choose not to participate.

The four-step compliance procedure, as you know, consists of three quantifiable and one subjective test. Depending on the step, benefit plans may or may not be combined for testing purposes.

This complicated series of tests will no doubt be a burden on small business owners and , as yet, they receive no assistance. The Internal Revenue Service (IRS), which is responsible for producing compliance regulations, has not done so. It appears that the law is so incomprehensible that even the IRS cannot untangle the web. If this agency is having problems, I hesitate to think how a small business owner will deal with compliance.

One option for employers would be to bring in consultants such as a Lawyer or Certified Public Account (CPA). Even though at a recent CPA seminar in California the CPAs believed the regulations of Section 89 to be a practical joke, one CPA has decided to charge his clients $5,000 per test. Apparently, the phrase "Ignorance is bliss" has taken on a new meaning.

It appears that a fee of $5,000 may be a bargain. A consultant for a Boston firm has quoted a figure as high as $50,000 for his services. According to a muffler dealer in Milwaukee, who employs 28, that is a high price to pay to comply with a law that really hasn't even been spelled out yet. In fact, an attorney from Kalamazoo, Michigan, claims that no one can possibly guarantee that a business will comply because the rules are so unclear.

The biggest dilemma facing small businesses, according to another Boston consultant, is indeed the enormous cost involved to attempt to prove you are complying. A landscaping and nursery business owner from Dallas, Texas, with 186 employees, feels that it will be more economical for him to drop his health coverage than to pay for these administrative costs.

An easy way out of this dilemma seems to be to simply eliminate all health plans. A startling example of this comes from a firm in Massachusetts which employs 20,000 people. After Section 89 was enacted, this company dropped its coverage completely. It gave its employees cash bonuses and made them search for their own coverage.

Figures show, however, that many small businesses may not have to go through this difficult procedure. The reason for this is that between 56-70 percent of their health care plans will not even pass the first test. These statistics may even be too low. Of the 20 plans a Michigan lawyer has tested, only 12 percent have passed.

The penalties for failure to comply with Section 89 will be extremely detrimental to employers and some employees. A small business owner in Texas says that the severity of penalties is astronomical and employees will take the brunt of the blow. He feels that it will be an unnecessary burden for his employees.

The sad fact is, according to a businessperson from Wisconsin, "Small Business simply cannot afford to treat every employee equally. As much as we would like to, if we did, we would either go bankrupt or lose our key employees." Section 89 will force small business owners to make this difficult choice and either way the decision goes, they, and in the long run all of their employees, will be the losers.

Finally, it is predicted that Section 89 will raise some $200 million in revenues. In actual fact, however, the costs of implementation and compliance will far outstrip this figure. This sentiment has been echoed time and again by small business owners, consultants and attorneys alike. Section 89 will also have an extremely negative impact on the budget.

Even with all the controversy caused by Section 89, a great many companies do not know the law exists or are ignorant of its ramifications. The owner of a cosmetics lab in Lawton, Oklahoma, which employs 150 people says she's totally unaware of the statute. At best, according to a consultant in Los Angeles, California, people are taking a wait and see attitude. Companies may be aware of the law, but are completely bewildered by its provisions.

In conclusion, I would like to point out that Section 89 seems to be a law that fails on facts and circumstance. I could design a benefit plan that everyone would consider to be nondiscriminatory, but, in fact, would be so according to Section 89. I could also design a plan that all would agree to be discriminatory, but, under Section 89, would not be. This type of inconsistency does not benefit anyone, least of all employees.

Section 89 is extremely detrimental to Small Business. It was designed to expand health care coverage, but will ultimately decrease it. While intending to benefit employees, Section 89 will end up harming them. Finally, Section 89 assumes guilt and forces small business owners to pay dearly to prove innocence.

NSBU believes that Section 89 was an attempt to mandate benefits without having a full and adequate hearing on the matter. We believe the framers of this law had their hearts in the right place, but they did not have adequate knowledge on how it would effect small business.

National Small Business United is a private, non-profit association of more than 50,000 small business owners from throughout the United States. Organized exclusively for small business owners, NSBU is a member-driven organization with a 30-member volunteer board of directors which sets policy and directs the Washington, D.C.-based staff.

STATEMENT OF
DON L. CORBETT

OWNER OF SERVICEMASTER PROFESSIONAL CLEANING OF FAIRLAWN

FOR THE
NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before:	House Small Business Committee
Subject:	Section 89 of the Internal Revenue Code
Date:	January 24, 1989

I am the owner of a small cleaning company which provides janitorial services and project cleaning to commercial buildings, plus residential cleaning of carpets, furniture, walls, etc. We also work with the insurance industry cleaning up after fires and floods. Our company presently employs 36 people including myself.

We presently provide hospitalization benefits for all employees who work 30 hours per week or more on a regular basis. We provide full payment for single employees and pay a like amount for married employees with them paying the difference.

Perhaps it is not a great program, but it costs our company approximately $1,900 per month on sales of approximately $36,000 per month; a very large sum.

Of the 36 employees, we have 12 who are working 30 hours per week or more; 15 working between 17.5 and 30 hours (averaging 22.5 hours/week), and 9 employees who work less than 17.5 hours per week.

Section 89 of the Tax Reform Act of 1986 says I have a discriminating plan; at least I think it does. It has been very difficult to determine exactly what the regulations say. I feel it is not right for a law to be so complicated that the people it affects cannot understand it.

I have received charts and pages and pages of writing that are supposedly trying to explain the regulation, and still it is unclear. The accountants I have contacted do not have a clear understanding of Section 89. One company that quoted on health insurance said one law firm is charging $2,000 to write up a plan so small businesses can be in compliance.

I am also concerned when the IRS brings out their clarification, they will be as clear as their clarification of last year's W-2 form.

As a small businessman, I want as many of my people to have hospitalization as possible. Even though our business is low in status, it is an important job and I need to have stability to provide our clients the quality we want to give.

I have done more than most cleaning companies in our area, as far as providing hospitalization is concerned, yet my plan is discriminatory. Why should employees working 17.5 hours per week be entitled to the same benefits as employees working 30 hours per week?

To be non-discriminatory a plan must be permanent. I am not in a position to say a plan is permanent. My hospitalization premium increased 90% last year. I changed to another company and the effective increase was brought down to 30%. This year one of our crew chiefs had a heart attack. My rates increased 70%, but because of the heart attack no other company will take our insurance unless he is dropped from the program. I can't in fairness do that, so I've elected to stay with the 70% increase.

If the rates continue to raise at those percentages, I can't promise I'll continue the program. I cannot raise my prices to cover these costs and remain competitive.

If the government wants business to handle health care, it is going to have to do something to stabilize the costs. Otherwise, there are going to be an awful lot of unstable jobs as businesses give up and throw in the towel.

I have a deep concern for my employees and want to do everything I can for them. I do not feel it is proper, however, to call a plan discriminatory when it does not cover employees under 30 hours.

Congress on the one hand says that it is concerned about the competitiveness of the United States business community compared with the rest of the world; and the recent trade figures indicate this is a legitimate concern; then it puts together a regulation that serves no useful purpose other than adding legal and accounting expense.

I presently spend a great deal of time and money to maintain records for the government and to collect taxes for the government. This regulation appears to add monumental amounts of recordkeeping and legal work that adds nothing to productivity. If Congress wants to raise the productivity of business, it must eliminate its adversarial role.

Congress should be developing incentives for employers to offer benefits to employees. These types of regulations, along with the volatility of benefit costs, negatively affect my thinking on the types of benefits I can offer to employees.

If Congress insists that some type of discrimination regulation is necessary regarding benefits, then it should be simplified and a more reasonable criteria established than 17.5 hours per week. My teenage daughter has babysat over 17.5 hours during a weekend.

This regulation will have no beneficial impact on employees. Large firms or firms with highly skilled employees probably already have good plans for their employees, but they will have to spend good money to prove it and to comply with the regulation. Firms that employ many unskilled employees will be changing their employees every six months. Some of the businesses in my line of work do that now, just to avoid the pressures of employees asking for raises and benefits. Now there is a regulation to encourage more of that.

Is the regulation really going to benefit employees or is it going to discourage employers from offering benefits?

In the long run, I feel it will have a negative impact on employees and business.

It is my opinion this regulation should be repealed in total as detrimental to business in general and employees in the long run.

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NFIB

National Federation of
Independent Business

SUBMITTED STATEMENT OF

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: House Small Business Committee
Subject: Section 89 of the Internal Revenue Code
Date: January 24, 1989

Mr. Chairman, on behalf of the more than half million small business owners who are members, the National Federation of Independent Business (NFIB) is pleased to submit this statement of our members' concerns with section 89 of the Internal Revenue Code (IRC).

NFIB applauds you for holding these hearings and for introducing legislation to repeal section 89 of the IRC. NFIB and its members strongly support repeal of section 89. We are concerned that section 89 will irreparably reverse the progress which is being made by the small business community to expand health insurance coverage for employees. We are concerned that compliance with section 89 will divert resources which could be spent on health coverage benefits. We are also concerned that section 89 will result in fewer employees covered; those who will be covered will not be able to receive the same level of benefits.

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The Guardian of
Small Business

As we will illustrate, section 89 imposes an unrealistic compliance scheme on employers for testing plans and recordkeeping. We will illustrate that the reality of section 89 flies in the face of the stated goal: to eliminate discriminatory health plans and expand health coverage benefits to more employees. We will illustrate that the true result of section 89 is a roundabout way to tax fringe benefits, a concept which Congress has traditionally strongly opposed.

Background

Section 89 of the IRC was a part of the Tax Reform Act of 1986 (TRA). In the General Explanation of the TRA published by the Joint Committee on Taxation, the following is stated:

> Under prior and present law, the tax favored treatment of employer-provided benefits reduces the Federal income tax base and reduces Federal budget receipts. However, Congress believed these costs are justifiable if such benefits fulfill important social policy objectives, such as increasing health insurance coverage among taxpayers who are not highly compensated and who otherwise would not purchase or could not afford such coverage.

According to the Joint Committee, the tax revenues to be raised by making these changes were to be $72 million in 1988, $128 million in 1989, $140 million in 1990, and $154 million in 1991, or a total of $494 million over four years. Given that the tax expenditure analysis reveals that the cost of the exclusion for health insurance will reach more than $30 billion, section 89 certainly was not created to have a substantial revenue effect.

Nevertheless, the real impact of section 89 might be to raise new revenues to be used for deficit reduction while imposing regulatory and compliance burdens that will cost small business owners several thousands of dollars a year to comply with.

Small Business and Fringe Benefits

Fringe benefits have become an increasingly difficult problem for small business owners. Both employers and employees are being affected by the rising costs of health insurance premiums and health care in general. Employer-sponsored group plans are popular because they afford an employee an opportunity to obtain health coverage at a cost that is far lower than he could purchase as an individual.

Unfortunately the small business owner is coming under increasing financial pressure to maintain current levels of coverage while insurance premiums increase 20% to 30% each year. It is no secret that small plans cannot receive the same benefit of lower costs that some larger employers can because of the economics of size. These cost increases are beginning to affect the types of coverages and options an employer can provide.

In surveys of NFIB members on fringe benefits, health insurance ranks as the most popular, with nearly two thirds of NFIB members providing some level of coverage for employees. It is also increasingly popular for an employer to provide dependent coverage with some level of employee participation. Section 89 will probably have its greatest impact on small employers vis-a-vis dependent coverage. Section 89 will also severely affect plans to increase coverage for current employees.

*Qualification Tests

Section 89 imposes new rules on employers to establish that a plan is qualified. To be considered as a qualified plan, an employer must take the following steps and meet the following requirements:

1) have the plan in writing;

2) provide that an employee's rights under the plan is legally enforceable;

3) provide employees notification of benefits available under the plan;

4) illustrate that the plan is for the exclusive benefit of employees; and

5) determine that the plan was established with the intention of being maintained for an indefinite period of time.

*Eligible Employees

The employer must determine which employees must be included in the plan. To do this the employer must determine which employees must be included in testing, which employees may be excluded from testing, and, most importantly, which employees are highly compensated.

*Excludable Employees

For testing under section 89, an employer may exclude employees who:

1) have not completed six months of service;
2) normally work less than 17 hours per week;
3) do not work more than six months per year;
4) have not reached age 21;
5) are covered under a collective bargaining agreement.

These rules require an employer to provide part-time employees, many of whom work 20 hours per week, with the same benefits as all full time employees. Small employers simply cannot afford to include all of these employees in their health plans, due to the costs involved, unless full-time employees are willing to reduce coverages and benefits, such as dependent coverage.

The definition of highly-compensated employees is particularly critical, for it is this group of employees and their level of benefits that will be compared to all other employees to determine if the plan is discriminatory. Highly compensated employees are defined as:

1)owners who own 5% or more of the business;

2)employees who are earning more than $50,000 or who are among 20% of the highest paid workers;

3)employees earning more than $78,353;

4)if an employee was at any time an officer of the business and received compensation greater than $30,000.

*Defining Employers

Under the rules of section 89, related groups or commonly-controlled organizations must be combined for purposes of testing under section 89. This will have inadvertent results as widely different businesses with common ownership may be forced into complying with section 89. Such commonly owned firms may be forced to drop coverages altogether.

*Determine Which Plans Must be Tested

Section 89 applies to the following type of employee benefit plans:

1) accident and health plans;
2) group term life insurance plans;
3) group legal service plans;
4) educational assistance plans;
5) dependent care assistance arrangements;
6) tuition reduction programs;
7) cafeteria plans;
8) Voluntary Employees' Beneficiary Association Plans;
9) supplemental unemployment benefit plans; and
10) Fringe benefit programs, including employee discount programs, and subsidized cafeteria facilities.

In defining which plans are to be tested, an employer is required to test each separate benefit option as a distinct and separate plan. The most common example of such a situation will be an employer health plan that offers one option of employee coverage, another option for dependent care coverage, the option of a typical insurance carrier, or an HMO.

Non-Discrimination Tests

Employee Data

For each employee a substantial amount of new data must be collected and updated annually. The type of data required will include the following for each employee:

1) Name and Social Security Number;
2) Date of Birth;
3) Date of hire;
4) Compensation (both cash and non-cash);
5) Benefit elections for accident or health plans;
6) With regard to health plans, sworn statements demonstrating the coverage elected by the employee, whether the employee has dependent family members, and whether the employee or any of his dependents have core health coverage maintained by another employer;
7) with regard to employees, whether any divorced spouses may have claims on the employees health coverage;
8) The employee's pre-tax and after tax contributions to each plan;
9) the employer's contribution to each plan;
10) the divisions the employee is a part of; and
11) whether the employee is considered part time or full time for purposes of section 89.

Percentage Tests

Having made all of these determinations, the employer must finally begin the actual testing of his plan. There are two routes to take in this regard. Some employers with simple benefit plans may qualify for the simpler testing method: two tests , one quantifiable and one subjective. All others must use a series of four tests, three quantifiable and one subjective.

Those with simple benefits plans must simply meet an 80% coverage test, which requires that 80% of all non-highly compensated employees be covered under each plan being tested. Failing this test, which the more complex plans will, requires a three part test:

1) At least 50% of all eligible employees must be non-highly compensated employees;

2) At least 90% of the employer's non-highly compensated employees must be eligible for a benefit that is at least 50% as valuable as the health benefit available to the highly compensated employees with the highest available benefits under the plan; and

3) the average employer-provided benefit received by the non-highly compensated under all plans of the type being tested must be at least 75% as rich as the average employer-provided benefit received by highly-compensated employees.

Valuation of Benefits

Most importantly the benefits that each employee is to receive must be valued according to regulations which the IRS has failed to issue. The valuation table that will be introduced will be the basis upon which any discriminatory benefits will be taxed.

Small Business Issues

Beyond the absurdity of the administrative requirements is the basic concept of section 89: test coverage instead of eligibility. Before tax reform employers were tested on their fringe benefits plans to determine if plans discriminated based on whether a fair cross section of employees were eligible to participate in an employer's fringe benefit plan.

Now eligibility is insufficient as a test of discrimination; actual participation in a plan will be the true test. So 80% must actually be participating under the plan and drawing equal benefits for a plan to be judged non-discriminatory. In a small business context, eligibility is a workable criteria because it requires an employer to make all benefits equally available.

Some will say that this rule has hurt some employees because a test based on eligibility can prevent some employees from obtaining coverage if the co-payments are set too high. This is a concern, but it is not typical of most small employers. Most small employers only require employee participation when the cost of coverage increases too much or for one of the benefit options.

What is of concern is that small employers struggling to provide some measure of coverage may drop their subsidized plans, and others who are considering beginning a plan may decide against it. Still other employers may choose to simply drop any pretense at offering qualified plans and require all employees to report all of their subsidized benefit as taxable income.

Small employers are not financially able to afford all of the benefits options some in Congress would like to provide employees for free, nor is the employer in a position to provide coverage for the broad number of part-time employees usually present in a small business.

Technical Corrections Act of 1988

In 1988 Congress passed a technical corrections bill to the 1986 TRA. Included in that bill were some adjustments to section 89. However, the adjustments were so minor in nature that they are not going to have any substantial affect on the cost of small employers to test, qualify, and administer a fringe benefit plan under section 89.

Conclusion

Small employers are being told by their benefits consultants and tax advisors that if they do not comply with section 89, the excess benefits of their highly-compensated employees will be taxed. To many this route will be preferable because the cost to raise the benefits to all of the part-time and other employees will be three to four times greater.

This is an example where the cost of compliance outweighs the penalty which might be applied. The question you must ask yourself is whether this will help to accomplish the goal of broader coverage. It would seem that section 89 will only frustrate those goals. It would seem that the only people benefitting from section 89 are the consulting firms who have made an industry out of packaging seminars and software to comply with section 89.

NFIB shares Congress' concerns in the area of health care for employees and employers. We encourage this Committee to send a strong message to the rest of the Congress that this concept will not work. Section 89 of the IRC needs to be repealed immediately, as penalties for failure to comply are being incurred as we sit here debating the issue.

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STATEMENT
on
IMPACT OF SECTION 89 ON SMALL BUSINESS
before the
COMMITTEE ON SMALL BUSINESS
for the
U.S. CHAMBER OF COMMERCE
by
Diane Large
January 24, 1989

Mr. Chairman and members of the Committee, my name is Diane Large. I am vice president for personnel and facilities management for the U.S. Chamber of Commerce. I am accompanied by Karen Berg, manager of human resources policy for the Chamber. Mr. Chairman, the Chamber applauds you for holding this timely hearing on the impact of Section 89 of the Internal Revenue Code on small business. Employers, including the Chamber, are just beginning to feel the effects of Section 89. Some smaller employers are only now hearing about the new benefit rules.

As a result, there is a great deal of confusion surrounding Section 89. The Chamber has been inundated with hundreds of calls. Some callers think that mandated health benefits legislation has passed; others have heard conflicting reports about what is required under Section 89 and want to know what they should do.

The ostensible purpose of Section 89 is to encourage employers to expand their benefit plans to include more lower-paid and part-time workers. The consideration and enactment of this provision have occurred at the same time that efforts have been made to increase health care coverage for the employed, as well as the unemployed. Small business has been the focus of the debate over expanding health care coverage because most of the working uninsured are found in small firms. Ironically, Section 89 will impede, rather than encourage, these efforts. Many smaller companies, as they discover the complexities of compliance, will decide not to offer benefits at all.

Employers have no quarrel with the concept of offering benefits to a broad cross section of employees in exchange for the tax breaks that they receive for providing benefits. But such rules should act as an incentive, not a disincentive, to providing coverage. Unless the rules are simple enough so that small businesses can understand, apply and pass the tests, small businesses will be discouraged from providing and maintaining benefit plans.

The complexity and rigidity of the new rules suggest to many that this actually may be a means to raise revenues cloaked in social goals. It seems as if Section 89 were designed to frustrate employers into taxing employee benefits. If that is so, Section 89 is a truly perverse law because it essentially penalizes those small employers who offer benefits and will discourage other businesses from offering coverage.

Mr. Chairman, it is the position of the Chamber that Section 89 should be repealed. We share the goal of expanding health care coverage for the nation's uninsured but believe that Section 89 will only exacerbate the problem.

I will focus my remarks upon the impact of Section 89 requirements on small businesses that offer benefits packages and the chilling effect that likely will have on small companies that are considering offering benefits plans, especially health care coverage. I then will suggest several alternatives that the Chamber believes will go much further toward expanding health care coverage among lower-paid and part-time workers.

Section 89 and Small Business

Mr. Chairman, small businesses are trying to comply with Section 89. Some may not know how to comply. Others -- for a variety of reasons -- may not be able to comply. Last spring, the Principal Financial Group, a major underwriter of health and life insurance for small employer groups, conducted a survey on the impact of Section 89 requirements among a selected group of its small employer clients, each with fewer than 10 workers. Most of these small businesses failed the Section 89 nondiscrimination tests.

Section 89 assumes that an employer is discriminating in the provision of its benefits unless the employer establishes evidence to the contrary. The burden of proof is upon the same employer that is also voluntarily providing health care coverage to its employees.

Section 89 is excessively complex, requiring employers to collect, maintain, and update vast quantities of information. This information is used to determine whether benefit plans are discriminatory and, if so, the additional income that must be imputed to highly paid employees who receive discriminatory employer-provided benefits. There are three primary tests under Section 89. Each group life and health plan must satisfy either an 80 percent participation test or both a 90 percent/50 percent eligibility test and a 75 percent benefits test. The 80 percent participation test requires that at least 80 percent of each employer's nonhighly compensated employees (and their dependents) be enrolled -- not just eligible -- for coverage. Under the 90 percent/50 percent test at least 90 percent of an employer's low-paid workers must be eligible for benefits at least half as valuable as those available to top management. Then the employer must demonstrate that the average value of the benefits actually received by low-paid workers is at least 75 percent of the average value of those given to highly paid workers.

Section 89 is causing problems for small companies whose plans would not be considered to be discriminatory by any reasonable definition. (The attached article from the February 1989 issue of Nation's Business discusses employers' frustration and problems in complying with Section 89.)

Employers must maintain detailed personnel records identifying employees and dependents by a variety of categories (i.e., full-time, part-time, insured or not insured, eligible or ineligible). Attached is a listing of the data that employers must collect. Few small companies are equipped with data bases to handle such a task.

The definitions under Section 89 also are causing problems for businesses. What a company considers to be one "plan" may actually be several plans -- each of which must be tested separately. Few companies define a "part-time employee" as one who works as few as seventeen and a half hours per week. A survey by the benefits consulting firm Foster Higgins found that just 6 percent of companies provide group health and life insurance coverage to employees working fewer than 20 hours a week.

Small businesses that do not traditionally rely on the outside counsel of attorneys and benefits consultants for their plans may find that they must because those that they usually rely on, such as insurance agents, may not understand the complex rules. A Gallup survey last fall of benefits managers in 400 companies nationwide found a great deal of confusion as to the timing, requirements, and penalties associated with the law. In companies with 300 or fewer employees, only 18 percent of benefits managers even knew what is required to test for compliance.

As a result, Section 89 will add thousands of dollars in administrative costs with little or no value to employees. Small businesses likely will have to spend proportionately more to comply with Section 89.

And even after spending thousands of dollars, employers still may not be certain that they are in compliance because the regulations for Section 89 have not been published yet. Even the most sophisticated tax lawyers in the country are uncertain about how Section 89 will be applied.

Businesses whose plans do not meet the nondiscrimination requirements under Section 89 essentially have four options: (1) revise the eligibility requirements and attempt to enroll enough part-time employees to meet the test; (2) reduce the working hours of part-time employees to less than seventeen and a half hours or use only full-time workers; (3) maintain the discriminatory plan as is and report the taxable income; or (4) terminate the plan.

Clearly, Section 89 cannot achieve its stated goal of expanding benefits coverage.

Expanding Health Care Coverage in Small Businesses

Small businesses want to offer health care coverage. Health coverage is the most prevalent fringe benefit offered by employers for firms with more than 10 employees. The provision of health benefits increases with firm size, with the gap narrowing considerably in firms employing 25 or more employees.

Small business employers with health plans are more likely than large firms to include part-time, temporary, or seasonal workers in health coverage plans. Small firms hire more of these types of workers and may make them eligible to broaden their risk-pool or to attract and retain these employees. The Chamber recently released its latest employee benefit survey, which found that in firms using part-time workers, those companies in which part-timers comprised more than 10 percent of the work force were more likely to award the same benefits to part-time and full-time workers.

Not surprisingly, however, the smallest enterprises are the ones with the least resources to enable them to provide health care plans; they also have the greatest employee turnover rate and the greatest likelihood of going out of business. A Small Business Administration analysis of the Bureau of Census's Survey of Income and Program participation data indicated that in 1984, 48 percent of all uninsured workers were employed by firms with fewer than 25 employees. If you include business owners without coverage, the figure rises to almost 60 percent of the uninsured.

There are several reasons for this. Small businesses have the most difficulty in providing health care coverage. Employers of all sizes are faced with rapidly rising health insurance costs. High employee turnover rates increase administrative costs and the employer's liability for health care continuation under COBRA. Narrow profit margins and competitive pressures also affect small businesses' ability to finance health coverage costs. In addition, small business employers often are unable to qualify for group policies.

U.S. Chamber of Commerce Alternatives

What can be done to encourage small businesses to expand benefits coverage? The Chamber has developed several alternatives that address the factors preventing businesses from offering health coverage:

1. 100 PERCENT DEDUCTION FOR SELF-EMPLOYED/UNINCORPORATED.

Mr. Chairman, I know that you recognize the potential that this has for encouraging expanded coverage. Self-employed business owners have been denied the incentives given to corporate business owners to obtain health insurance. Currently, an unincorporated business may deduct only 25 percent of the expenses for health-care coverage for the business owner. Unincorporated firms are about half as likely as corporations to provide health care coverage to owners and workers. Treating unincorporated businesses, such as sole proprietorships, the same as corporations for purposes of the tax deductibility of their health-care expenses would encourage coverage by the very smallest enterprises, in which lack of coverage is the greatest.

2. ERISA PREEMPTION OF STATE INSURANCE MANDATES.

More than 640 state mandates require insurers to include specified benefits in health plans (e.g., drug treatment and mental health coverage). These mandates make insurance more costly to small business. Preemption would enable insurers to offer basic group coverage more affordably.

3. REMOVAL OF REGULATORY OBSTACLES TO EXPANSION OF MULTIPLE EMPLOYER TRUSTS (METs).

METs are group arrangements formed by small firms to obtain health care coverage on a more cost-effective basis than a small firm might achieve alone. Often, METs are sponsored by chambers of commerce or trade or professional associations. The Greater Cleveland Growth Association and several other chambers have established successful METs. However, numerous federal and state regulatory impediments discourage the proliferation of these arrangements.

Conclusion

We do not have all of the answers to what is clearly the serious but very complicated problem of providing health care coverage for the uninsured.

The Chamber stands ready to work with the Committee to develop alternatives to expand coverage for the uninsured who are connected to the work force without placing excessive burdens on small businesses.

Trying to coerce businesses to expand benefits coverage by means of complicated tests and stiff penalties simply will not work. The underlying factors of cost and availability of group plans must be addressed. We also must provide incentives for self-insured persons to purchase health insurance. Taking these initial steps will go a long way toward expanding benefits coverage by small firms.

2 Attachments

ATTACHMENT 1

"Government Gone Crazy"

By Roger Thompson

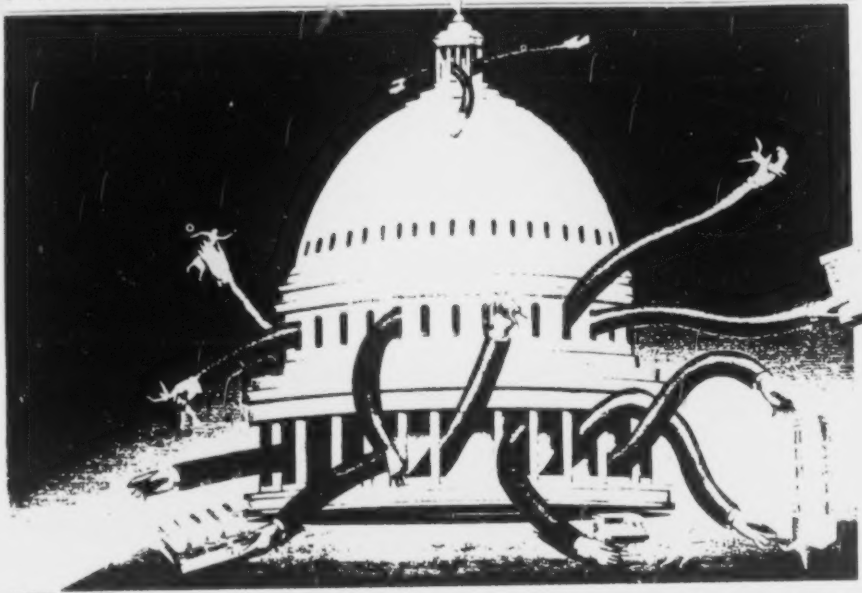


ILLUSTRATION: DALE GLASGOW

It was the end of another long day for Steven Ferruggia, whose mastery of a new, perversely complex federal benefits law has generated more consulting business than he can comfortably handle. His students—42 business owners, benefits managers, lawyers, and consultants—had paid $195 apiece for an all-day workshop at Boston's Logan Airport Hilton. Participants had flown in from across New England and from as far away as Houston.

Ferruggia and two colleagues from New York-based Buck Consultants performed feats of verbal alchemy, laying out in clear English what Congress had cloaked in turgid prose. But no amount of explaining would relieve the sense of quiet desperation that pervaded the room. Puzzled looks and furrowed brows revealed by expression what went unspoken: This time, Congress had gone too far.

"I think this law will cause a lot of small employers to dump their benefit plans," Ferruggia said in a private moment after the workshop. "It's big government gone crazy," said Edward Maguire, a consultant with Sapers & Wallack in Cambridge, Mass.

The law in question is Section 89 of the federal tax code, one of several provisions that affect employee benefits and were added by the 1986 Tax Reform Act but were not effective until Jan. 1, 1989. Section 89 sets stiff tax penalties for employer-paid health insurance, life insurance, and other nonpension employee benefit plans that favor higher-paid workers.

Businesses that discriminate in favor of higher-paid workers have two choices: broaden and/or extend coverage to lower-paid workers or report the "discriminatory" portion of the higher-paid workers' benefits as taxable income.

Also effective Jan. 1 was another tax-law change that, while it has not drawn as much criticism as Section 89, could

BENEFITS BLUNDER

A misguided attempt by Congress to make benefits fairer for lower-paid workers puts employee plans at risk because many smaller companies—as they discover the complexities of compliance—may be discouraged from offering benefits at all.

prove no less burdensome to some employers. The change requires employer-provided retirement plans—including pension, profit-sharing, and so-called 401(k) savings plans—to meet rigid tests for fairness to workers who are not in the "highly paid" category defined in the law. Failure to comply with minimum coverage and participation requirements could result in loss of tax-favored status for both the plan sponsor and the plan participants. (See box on Page 24.)

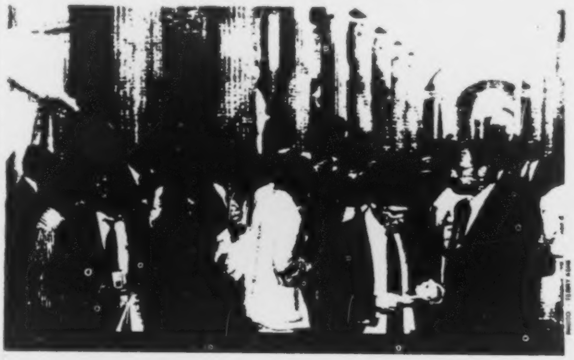
Taken together, the new requirements imposed by Section 89 and the new pension-plan rules represent Congress' deepest penetration yet into the employer-provided benefits system. Experts say the two provisions encompass more changes and affect more plans than even the sweeping 1974 Employee Retirement Income Security Act (ERISA). That law placing intricate controls on employer-provided pension plans marked Congress' first concentrated attempt to regulate private-sector employee benefits. Since then, the lawmakers have amended and expanded employee-benefits laws almost annually, often to the confusion and dismay of employers.

In enacting Section 89, Congress said its goal was the extension of benefits, especially health insurance, to millions of lower-income workers who are inadequately covered or not covered at all. Under the law, part-time employees who work as few as 17.5 hours a week must be included in calculations to determine whether plans are discriminatory.

The congressional Joint Committee on Taxation explained its intent this way: "The [Section 89] non-discrimination rules should require employers to cover non-highly compensated employees to an extent comparable to the coverage of highly compensated employees."

But those who are familiar with Section 89 contend that it will have the opposite effect. "It will tend to decrease flexibility and increase administrative costs," says Frederick J. Krebs, manager of business and government policy for the U.S. Chamber of Commerce. "The effect will be fewer benefits and fewer businesses offering benefits."

Lobbyists mill around outside the congressional conference committee during its marathon sessions on the Tax Reform Act of 1986.



If King George and Parliament had come up with anything like Section 89, it wouldn't have taken seven years to win the Revolutionary War.

THOMAS VEAL
TOUCHE ROSS AND CO.

"When you look at the cost of compliance, it's just not worth it," says Garry Jerome, a consultant with Mercer Meidinger Hansen Inc., in Philadelphia.

Many major industrial companies expect to spend more than $1 million on compliance costs. An employer with 500 workers can expect to pay upwards of $25,000 for a consultant. A firm with 200 workers could pay $10,000 or more. Small companies may have trouble finding advice for less than $1,000.

The high price of compliance is driven by the law's complexity. Section 89 is an administrative nightmare because it takes what appears to be a simple health plan—like those offered by many small companies—and multiplies it into several plans for testing purposes. Take a medical plan that offers coverage for single workers, workers with children, and workers with spouses, with each option offering two different deductibles. Under Section 89, that plan becomes six plans, and each

It's big government gone crazy.

Edward Maguire
Sapers & Wallack

must meet the non-discrimination tests. Some major corporations with multiple plants and various benefit packages will have hundreds of plans to test.

Because the chances of failure to comply increase with the number of options available to employees, many employers will feel pressure to cut back on choices now available and steer clear of providing new ones.

The enormous complexity of Section 89 has prompted its critics to speculate that Congress was more interested in raising revenue than expanding benefits. "It's really a revenue statute dressed up to look like a do-gooder statute," says Howard C. Weizmann, executive director for the Association of Private Pension and Welfare Plans.

The joint tax committee estimates that Section 89 will net about $300 million a year in revenue derived largely from treating a portion of higher-paid employees' benefits as taxable income. But Congress may have greatly underestimated the law's impact for two reasons.

First, lawmakers may have been too optimistic about the law's ability to persuade employers to extend benefits to lower-paid employees. Kent A. Mason, the law's chief architect, told a health-care seminar in December that in most cases, employers will count any discriminatory excess benefits as income to highly paid workers and will "gross up" those employees' salaries—that is, increase their salaries to cover the newly taxable portion of benefits. "This option is much cheaper than extending benefits to low-paid workers," said Mason, who was counsel to the joint tax committee and now works for the Washington law firm of Caplin & Drysdale.

Second, widespread non-compliance would produce huge amounts in unanticipated tax penalties, warns Mary Hevener, a benefits attorney with the Washington law firm of Lee, Toomey & Kent. Employers who fail to comply with the non-discrimination rules will pay a tax penalty, calculated at the highest individual tax rate, on the benefits received by the highly compensated.

In addition, employees will be taxed on any benefits they receive if the employer fails to maintain a so-called qualified plan, which entails compliance with another set of rules similar to those already applied to pension plans.

Ferruggia and other consultants should be delighted about Section 89. Washington insiders regard it as a consultants' full-employment act. But consultants find themselves in the uncomfortable position of serving as shock troops for advancing a law that almost nobody can believe Congress actually passed.

Pat Haines, senior consultant in the Philadelphia office of the Coopers & Lybrand accounting and consulting firm, says the general reaction she gets from business audiences is, "I can't believe this is happening."

"I think if we are going to cause another American Revolution, Section 89 is it," says Thomas Veal, senior tax manager with Touche Ross and Co. in Washington. "If King George and Parliament had come up with anything like Section 89, it wouldn't have taken seven years to win the Revolutionary War."

In fact, Section 89 slipped through the tax-reform process with little notice. "No one focused on benefits changes" in the 1986 tax-reform legislation, said a Senate aide. "They just sort of happened."

Continued on Page 24

How To Comply With Section 89

Section 89 of the Internal Revenue Code denies tax-favored treatment of employer-provided benefit plans that discriminate in favor of employees who are highly paid. The law became effective Jan. 1 and applies to all employers, public and private. Only churches are exempt.

The law has two distinct parts: qualification rules similar to those for pension plans, and non-discrimination rules. The qualification rules are less difficult to handle but more onerous in their penalties. These rules apply to all tax-favored employee benefits.

There are five tests for maintenance of a "qualified" plan. It must be in writing, employees' rights must be legally enforceable, employees must be notified of the plan's benefits, the plan must be exclusively for employees, and the plan must be maintained indefinitely. Employers have until Dec. 31, 1989, to put the necessary documents in order, but they must operate the plan in accordance with its provisions from the beginning of the year.

Failure to meet any of the qualification requirements carries severe penalties in the form of extra taxes for employer *and* employees. All employees will be taxed on the payouts they receive from an employer-provided plan. For example, if the company's health plan pays out $50,000 on behalf of an employee with a catastrophic illness, that money becomes taxable income to the employee.

In addition, employers who fail to report benefit payouts on employees' W-2 forms must pay an excise tax on the total payouts, calculated at the highest individual tax rate.

The non-discrimination rules form the heart of Section 89 and apply only to employer-provided health-care, accident, and group life-insurance plans. These rules pose the toughest compliance problems.

Before testing for discrimination, an employer first must assemble a considerable amount of data, including the number of the company's highly compensated employees, the number of employees excluded from testing, and the number of benefits plans subject to testing.

For the typical small business, highly

compensated employees are those who are 5 percent owners or who earned at least $52,235 in 1988. The dollar amount will rise yearly to reflect inflation.

Excluded from testing are employees under age 21, anyone who works less than six months a year, anyone who has not completed a year of service (or six months of service for core health benefits), anyone who works less than 17.5 hours a week, and employees subject to collective-bargaining agreements.

Some small businesses—those with nine or fewer employees—may take three years to phase in coverage of part-time employees, defined as those who work at least 17.5 hours a week.

If an employer provides benefits to even one person in an excluded group, the exclusion is denied, and everyone in that group must be included in testing.

For testing purposes, a benefit plan may be viewed as more than one plan. Each variation in coverage, employer or employee contribution, copayment, or deductible creates a benefit plan that must be tested separately. For example, a medical plan that offers single-person and family coverage and two levels of deductibles is actually four different plans for testing.

Employers have two ways to prove that their plans do not discriminate:

- **80 Percent Coverage Test.** This is the less complex of the two methods. A plan passes this test if 80 percent of the employees who are not highly compensated actually receive coverage.
- **Eligibility And Benefits Tests.** As an alternative, an employer may show that the company's plan passes each of the three following tests:

90 Percent-50 Percent Eligibility Test. Ninety percent of the non-highly compensated employees must be eligible for benefits at least 50 percent as valuable as benefits for highly compensated employees.

50 Percent Eligibility Test. At least 50 percent of non-highly compensated employees must be eligible for a benefit under the plan, or the percentage of eligible highly compensated employees is no higher than the percentage of eligible non-highly compensated employees.

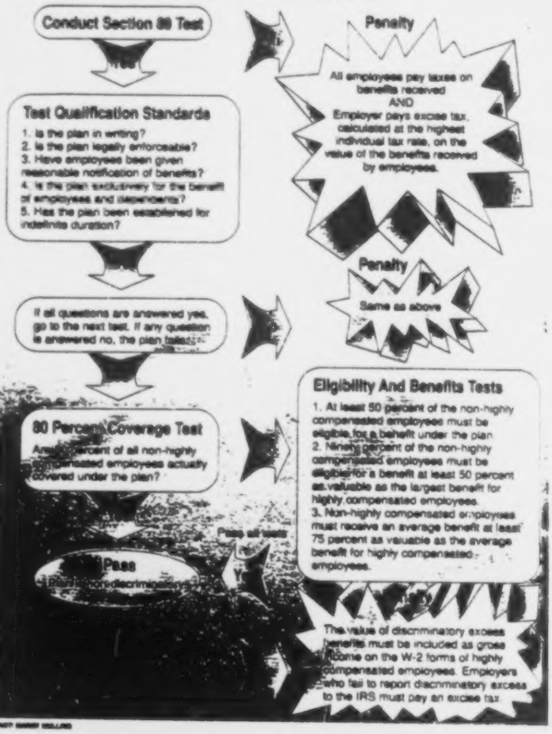
75 Percent Benefits Test. Non-highly compensated employees must actually receive an average benefit at least 75 percent as valuable as the average benefit for highly compensated employees.

Cafeteria plans, which allow employees to choose among several options for health and other benefits, are subdivided and tested like any other plan. Each option is a separate plan for testing purposes. Benefits provided through salary-reduction plans also are treated as separate plans for testing.

There is no penalty imposed on the employer for maintaining a discriminatory plan. But the employer must determine the amount of discriminatory excess received by the highly compensated employee and report it to the employee and to the IRS as taxable income. If an employer fails to report the discriminatory excess to the IRS, the penalty is an excise tax, calculated at the highest individual tax rate, on total benefits received by the highly compensated employees.

Employers pass or fail the non-discrimination tests based on the benefits available on any one day in the 1989 plan year. For 1989, employers may choose the last day of the year to perform the tests.

Section 89 At A Glance


Conduct Section 89 Test
Yes
Test Qualification Standards
1. Is the plan in writing?
2. Is the plan legally enforceable?
3. Have employees been given reasonable notification of benefits?
4. Is the plan exclusively for the benefit of employees and dependents?
5. Has the plan been established for indefinite duration?
If all questions are answered yes, go to the next test. If any question is answered no, the plan fails.
80 Percent Coverage Test
Are 80 percent of all non-highly compensated employees actually covered under the plan?
Pass
Plan is nondiscriminatory
Pass all tests
Penalty
All employees pay taxes on benefits received
AND
Employer pays excise tax, calculated at the highest individual tax rate, on the value of the benefits received by employees.
Penalty
Same as above
Eligibility And Benefits Tests
1. At least 50 percent of the non-highly compensated employees must be eligible for a benefit under the plan
2. Ninety percent of the non-highly compensated employees must be eligible for a benefit at least 50 percent as valuable as the largest benefit for highly compensated employees.
3. Non-highly compensated employees must receive an average benefit at least 75 percent as valuable as the average benefit for highly compensated employees.
The value of discriminatory excess benefits must be included as gross income on the W-2 forms of highly compensated employees. Employers who fail to report discriminatory excess to the IRS must pay an excise tax.

Do You Have Questions?

If you want to ask us questions about Section 89, we'll answer them in future issues of the magazine. Write to us at *Nation's Business*, Section 89 Question, 1615 H Street, N.W., Washington, D.C. 20062.

Continued from Page 22

Now, many employers are dragging their feet on compliance, waiting for it to collapse under its own weight. "We are hearing from employers who are predicting that Congress will repeal Section 89 sometime in [1989] after the outcry [over its complexity] begins," says Ken Feltman, executive director of the Employee Council on Flexible Compensation. He estimates that 60 percent of all businesses, primarily small companies, have not yet heard about Section 89, making ignorance of the law a major obstacle to compliance.

While large and midsized firms typically are staffed to keep abreast of changes in benefits laws, many small firms don't have the facilities to do so.

Observes Donald Utter, owner of Medical Personnel Pool, in Madison, Wis.: "It's the one secret that the government has been able to keep. Almost every small-business person I mention it to doesn't know what I'm talking about."

But small-business owners shouldn't assume that Congress will come to the rescue. Section 89 has powerful friends on Capitol Hill, including the two key

New Rules May Force Rewriting Of Pension Plans

Employer-sponsored retirement plans, starting this year, could be denied tax-favored status unless they meet strict new standards for fairness to lower-paid workers. To avoid severe financial penalties for themselves and their employees, many firms will have to revise their pension plans, especially sections covering eligibility requirements and methods of determining benefits.

The new rules, part of the Tax Reform Act of 1986, will hit some small businesses especially hard. Many small firms with few employees lack the flexibility to set up distinct pension programs that will satisfy new minimums for employee participation and coverage.

Some plans whose benefits are integrated with Social Security, sometimes to the disadvantage of lower-paid employees, will have to be revised or scrapped. Other plans will be affected by changes in the definition of highly compensated employees and by curbs on plans that provide generous benefits to only part of an employer's work force. The law defines as highly compensated the owners, part owners, and certain other company decision makers as well as employees currently paid more than $52,235 a year.

"Many employers will have to reformulate their programs from the ground up—a process that is likely to be time-consuming and may require high-level management decisions," says Thomas Veal, senior tax manager in the Washington Service Center of the accounting firm of Touche Ross and Co.

Small firms particularly may lack expertise and have to rely on expensive consultants to see that their pension plans meet these new requirements:

- **Participation.** A plan must benefit at least 50 employees, or at least 40 percent of all employees—whichever number is lower.
- **Coverage.** A plan must satisfy at least one of the three following minimum tests: (1) It covers at least 70 percent of all employees who are not highly compensated. (2) The number of covered employees who are not highly compensated equals at least 70 percent of the number of highly compensated employees who are covered. (3) At least 70 percent of all employees must benefit, and the average benefit for employees who are not highly compensated must be at least 70 percent of that for highly compensated employees. All of a company's tax-qualified retirement plans, including profit-sharing and 401(k) plans, must be included when determining each participant's average benefit.
- **Integration.** Employers previously could treat their retirement plans and Social Security as a single, integrated plan in determining whether overall retirement income unfairly favored higher-paid employees. New benefit formulas will sharply limit integrated plans, forcing many firms to raise benefits for lower-paid employees or reduce benefits for higher-paid employees.

Plans operating on a calendar year were supposed to have been in compliance with the new standards by Jan. 1, others by the start of their own 1989 plan years.

Even so, most employers have not yet tested their plans for compliance, much less revised them to conform with the new rules. One often-cited reason for not acting is the Internal Revenue Service's own delay in drafting regulations explaining how it will apply the law in various situations. As of Jan. 1, the IRS had released only its proposed regulations for integrating pensions with Social Security. Some experts speculate that the rest of the regulations, affecting the most controversial aspects of the new law, may not be ready for months.

Congress last year refused requests from business to delay the law's effective date. It did, however, recognize the difficulty of interpreting the new rules by absolving from penalty those plan sponsors who, in the absence of regulations, make "good-faith" efforts to follow the law's intent. "We did not get the delay that we wanted, and some people may still be in violation of the rules when the actual regulations come out," says David L. Wray, president of the Profit Sharing Council of America, which promotes profit sharing as a practice. "But at least people are off the hook for now."

However, experts say that plan administrators by now should have examined their companies' programs to determine, as best they can, whether the plans pass Congress' new fairness tests.

"I tell clients to take the worst-case scenario, just so there won't be any surprises when the regulations are issued," says Roy K. Sinclair, senior vice president of Booke & Co., an employee-benefits consulting firm in Winston-Salem, N.C.

Veal of Touche Ross sees a silver lining in the new rules for some employers. "The biggest problem," he says, "is going to be in sitting down and thinking out what the company's retirement objectives are and what it is trying to do in its pension, profit-sharing, 401(k), or whatever. That's probably a useful exercise. Some companies may discover that they'll be better off, because they've been going along for years with plans that didn't make any sense for them, that they'd just been throwing money into them without doing anything that the employees considered valuable."

—Donald C. Bacon

PHOTO · RICK FRIEDMAN—BLACK STAR

I think this law will cause a lot of small employers to dump their benefit plans.

STEVEN FERRUGGIA
BUCK CONSULTANTS

figures behind the 1986 Tax Reform Act—Rep. Dan Rostenkowski, D-Ill., chairman of the House Ways and Means Committee, and Sen. Bob Packwood, R-Ore., ranking minority member of the Senate Finance Committee.

The law reflects a longstanding concern among many lawmakers that the federal government doesn't have enough control over who gets tax-exempt, employer-paid benefits, according to staffers on the tax-writing committees. The joint tax committee estimates that employer-provided health-care plans alone cost the government $32 billion a year in "lost" revenue.

That kind of money, Congress decided, should produce better social-policy results, namely health insurance for lower-paid workers. Section 89 was driven by the perception that many employers were giving their highest-paid employees generous benefits while giving their lower-paid employees less or nothing at all. Supporters of this view note that 52 percent of the 37 million Americans who have no health insur-

The Ever-Tightening Federal Grip On Employee Benefits

Congress' grip on private companies' employee benefits has grown increasingly firm since 1974, as shown in the following legislative chronology.

1974. Employee Retirement Income Security Act (ERISA). Established minimum participation, vesting, funding, and termination standards for employer-sponsored pension plans. Mandated prefunding of pension benefits. Prohibited pension plans, or sponsoring employers, from reducing benefits to recipients. Created the federal Pension Benefit Guaranty Corp. (PBGC), funded by employers, and set an annual premium of 50 cents per participant—paid by employers—to insure private-sector pension plans.

1980. ERISA Amendments. Tightened funding requirements and limited federal liability for multiemployer pension plans covering some 8 million workers in the construction and other industries. Established standards governing the merger or transfer of multiemployer plans. Allowed employers' annual premiums to the PBGC to rise to $2.60 per pension-plan participant.

1982. Tax Equity and Fiscal Responsibility Act (TEFRA). Set limits on benefits in "top-heavy" pension plans in which key employees accrue more than 60 percent of benefits. Imposed special rules to assure minimum coverage, faster vesting, and other benefits for pension-plan participants who are not key employees. Revised requirements governing integration of pension-plan benefits with Social Security. Amended the rules for computing the share of employer-paid group life-insurance premiums to be included in an employee's adjusted gross income.

1984. Retirement Equity Act. Made 21 the age at which employees must be allowed to enroll in pension plans; the minimum age for many plans had been 25. Required employers to begin counting at age 18, instead of 22, an employee's years of service for pension vesting. Permitted employees to leave a job for five years—longer in some cases—and return without losing pension credit. Barred pension plans from counting a one-year maternity or paternity leave as a break in service.

1984. Deficit Reduction Act. Sharply curtailed the tax advantages of voluntary employee trust funds, the primary mechanisms available to employers for prefunding retiree health benefits.

1985. Consolidated Omnibus Budget Reconciliation Act (COBRA). Required employers with more than 20 employees to make available health-care coverage for up to 18 months to employees who leave the company for any reason other than gross misconduct. Also extended coverage to widows, divorced spouses, and some dependents for up to 36 months. Raised the employer's annual premium to the PBGC to $8.50 per worker.

1986. Tax Reform Act. Established comprehensive non-discrimination rules for coverage and participation in employee plans for health, life insurance, and other welfare benefits. Made sweeping changes in rules affecting coverage, participation, and vesting of tax-favored private pension plans. Tightened rules governing 401(k) programs. Restricted tax-deductible contributions to 401(k) plans and Individual Retirement Accounts (IRAs).

1987. Omnibus Budget Reconciliation Act (OBRA). Stiffened ERISA requirements for advance funding of employer-sponsored pension plans. Required employers to begin prefunding tax-qualified pension plans quarterly, instead of annually, starting in 1989. Boosted employer premiums to the PBGC to $16 per worker.

1988. Technical and Miscellaneous Revenue Act. Included, among hundreds of technical corrections and clarifications to existing tax law, multiple substantive changes affecting the rules applying to virtually all statutorily recognized employee benefits. Eased slightly some of the most controversial non-discrimination rules, enacted in 1986, covering employee welfare and pension benefits.

To expect small business to understand Section 89 is . . . ludicrous.

RON DANILSON
PRINCIPAL FINANCIAL GROUP

ance either work full time or are members of families headed by full-time workers. Accordingly, Congress cracked its tax-policy whip, forcing employers to fall into line or risk losing a tax subsidy for highly paid workers. Said one congressional staff member who worked on the legislation: "Why should the government be satisfied that blue-collar workers are getting less than white-collar workers?"

Business owners generally have no quarrel with Congress' intent. It's the execution that has benefits managers throwing up their hands in frustration.

Most large and midsized companies have turned to outside consultants for assistance. Small firms may find they have no other choice, says Feltman, of the Employee Council on Flexible Compensation. "In the end, what we have is a technician's dream and a layman's nightmare," he adds, explaining that Congress made Section 89 "so complex that the traditional expert that the small-business owner has relied on, his insurance broker, is no longer an expert. Now he'll have to go to higher-priced talent: lawyers, accountants, and consultants."

Reed Creaser, secretary/treasurer for General Crane and Hoist Inc., in Richmond Hill, Ga., already knows what it's like to ask questions and get no answers. "I've asked several insurance companies to send me what they have on Section 89, but nobody has sent me anything yet. The individual agents seem to be as much in the dark as we are," he says.

Whether individual employers discriminate or not, the law puts the burden of proof on them. Collecting and analyzing the data needed on each employee frequently may cost more than correcting any discrimination that is found. In fact, an employer may sink thousands of dollars into data collection

Employers' Payroll Costs For Employee Benefits

The yearly cost of private-sector employee benefits climbed in 1987 to an average $10,708 per full-time worker, compared with $10,283 the year before, according to *Employee Benefits 1988*, a new U.S. Chamber of Commerce survey of large, midsized, and small businesses. Average employee benefits as a percent of payroll dipped slightly to 39 percent in 1987 from 39.3 percent in 1986, the survey found. The decline, the Chamber said, indicated that **benefits are rising but at a slower pace than pay.**

"The study of employee benefits issues is more than just a matter of idle curiosity," said Richard W. Rahn, vice president and chief economist of the Chamber.

"In the past year a number of bills have been introduced in Congress that would mandate employers to provide health-care, parental-leave, and other benefits at federally mandated levels. With the information provided in this survey, employers can determine the impact of such legislation by analyzing the cost of providing benefits to their employees and by understanding the full cost of an individual employee."

Health insurance was the most widely provided voluntary benefit reported. Ninety-nine percent of the companies indicated at least some payment toward employee health care. The only benefits as widely available to employees were the legally mandated ones—Social Security, unemployment compensation, and workers' compensation.

Hospital, dental, and other medical coverage cost employers an average $2,189 per worker in 1987, virtually unchanged from $2,184 the year before. Stringent cost-containment programs, begun in 1987, helped keep down such expenditures despite a 6.6 percent jump in medical costs generally, a Chamber spokesman said.

Benefits varied significantly among industries, with costs in dollar value and as a percent of payroll generally higher among manufacturing firms than among service-sector firms. The Chamber noted, however, that service **firms are increasing their benefits at a faster clip than manufacturing firms.**

Sharp regional variations in benefit costs also appeared. Companies in the East North Central area, home of [illegible]ny older companies with huge liabilities for retirees' pensions and health-care benefits, paid more than 44 percent of payroll on employee benefits in 1987. In other regions, outlays ranged from 36.2 percent of payroll in the Northeast to 39.2 percent in the Southeast.

Payment for vacations, holidays, and other leave appeared to be the fastest-growing employee benefit, averaging 11 percent of total payroll cost in 1987, up from 10.2 percent in 1986. The survey turned up a trend in the paid-leave field: Some firms have begun offering employees a fixed number of leave days each year to use as they like for vacations, holidays, and sick leave.

As in previous years, **larger companies reported higher expenditures for employee benefits than did smaller companies.** The highest amount—39.5 percent of payroll—was paid last year by companies with 5,000 or more employees. Firms with 10 to 49 employees paid the lowest, 31.9 percent of payroll.

Employee Benefits 1988 is the 26th such survey by the Chamber. Originally biannual, it has been conducted yearly since 1979. For a copy, send $20 to Employee Benefits, U.S. Chamber of Commerce, 1615 H Street, N.W., Washington, D.C. 20062, or call (301) 468-5128.

—*Donald C. Bacon*

and analysis just to show that no discrimination exists.

Among the law's data requirements are those that compel employers to:

- Identify the highly compensated and the non-highly compensated.
- Determine who may be excluded from the tests.
- Identify each benefit that must be tested.
- Sort out the family status of employees for separate family coverage testing.
- Determine the number of former employees subject to testing.
- Determine whether parts of an organization can be tested as a separate line of business.

Once the information is assembled, it isn't enough to show that coverage was offered. Benefit plans will be judged by the percentage of employees who actually participate.

The Section 89 Coalition, a group of 190 associations and businesses, lobbied unsuccessfully last year for a one-year delay in Section 89. The coalition's efforts were motivated in part by the Treasury Department's failure to produce regulations to implement the law. But Congress was in no mood to start chipping away at tax reform, especially when delay would add $300 million to the federal budget deficit.

"The coalition met very heavy resistance from Rostenkowski," said Christine Hartoft, a legislative assistant with the Association of Private Pension and Welfare Plans. "He wasn't interested in anything that would make it look like tax reform was unraveling."

Nonetheless, the Technical and Miscellaneous Revenue Act of 1988, signed into law Nov. 11, did contain some of the coalition's recommendations for simplifying the law. Among them:

- Employers may test their benefit plans for compliance with non-discrimination rules on one day of the year; they do not have to track each benefit choice by each employee for each day of the year.
- Benefit plans will not fail the nondiscrimination tests simply because too many employees choose to be covered by their spouses' plans.
- Companies with nine or fewer workers may phase in coverage for part-time employees, those who work at least 17.5 hours a week, over three years.

The latter two changes are major concessions to the concerns of small companies, says Ron Danilson, assistant director of group operations with the Principal Financial Group of Des Moines, Iowa. A 1988 company survey of 100 employers with fewer than 10 workers found that up to 70 percent would fail, primarily because of the initial participation requirements for part-timers and workers covered by a spouse's insurance plan.

But even with the changes, the law and the monumental problems it poses for employers remain basically intact. "To expect small business to understand Section 89 is absolutely ludicrous," says Danilson. Others who have studied the revisions still don't like what they see.

"It seems to me that if a company is considering putting in a health-care plan, and they run into this, they will just forget it," says Frank L. Mason, president of the Mason Corp., a Birmingham, Ala., manufacturer of metal building products.

"It's just too much of a burden to keep up with all the detail and still run a business," he adds. "You can just load a small-business wagon so full, and when you get beyond that, something has to give." ■

To order reprints of this article, see Page 60.

For More Information

The U.S. Chamber of Commerce has prepared two booklets that explain Section 89 for employers. "Nondiscrimination Rules for Employee Welfare Benefit Plans," a 27-page publication, includes footnoted legal citations. For a copy, write to Hugh McCahey, Manager, Association Department, U.S. Chamber of Commerce, 1615 H Street, N.W., Washington, D.C. 20062. Ask for Publication No. 0123. The prices are $5 apiece for the first nine copies, $4 each for 10-99 copies, and $3 each for 100 or more copies.

A more concise explanation is contained in the Chamber's publication entitled "A Brief Explanation of Section 89 of the Internal Revenue Code." For a free copy, write Section 89, Employee Relations Policy Center, U.S. Chamber of Commerce, 1615 H Street, N.W., Washington, D.C. 20062.

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ATTACHMENT 2

DATA REQUIREMENTS FOR SECTION 89

Employee Number
Employee SSN
First Name
Last Name
Full Address
Date of Birth
Date of Hire
Marital Status
Number of dependents
Total Compensation
Bonus Mode
Bonus Amount
Compensation Mode
Employee Compensation
Normal hours per week
Normal number per month
Officer
Stockholder
Percent of stock owned
Collective Bargaining Agreement
Union #
Other Coverage Statement
Resident/work Visa
Location
Medical Plan information
Life Plan information
125 Plan information
Section 132 Plan information
Section 505 Plan information
Employee booklet
Insurance Policies
Last carrier billing
Annual Report
Proxy
Form 10-K
List of Officers
Prior year annual salary paid
Prior year officer status
Line of business with which work is associated
Citizenship status
Employee status (i.e., active, retired, terminated, etc.)
Date of retirement or termination, if applicable

SKILL RESPONSIBILITY INTEGRITY

THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

1957 E Street, N.W. • Washington, D.C. 20006 • (202) 393-2040 • TELEX 279 354 AGC WSH

JAMES W. SUPICA, *President* PAUL EMERICK, *Senior Vice President* KIRK FORDICE, *Vice President*

RICHARD E. FORRESTEL, *Treasurer* HUBERT BEATTY, *Executive Vice President*

January 24, 1989

John T. LaFalce
Chairman
Committee on Small Business
2367 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Chairman:

I am enclosing for your information five copies of the Associated General Contractors of America testimony to be submitted for the hearing record of January 24, 1989, on the Section 89 Nondiscrimination Requirements.

AGC is most appreciative of this opportunity to present our industry's views on this important issue.

Sincerely,

Mary Jo Peterson
Director
Congressional Relations/
Tax and Fiscal Affairs

MJP/cmc

Enclosure

THE FULL SERVICE CONSTRUCTION ASSOCIATION FOR FULL SERVICE MEMBERS

Statement of
The Associated General Contractors of America
Presented to the
Committee on Small Business
of the
United States House of Representatives
on the Subject of
The Section 89 Nondiscrimination Requirements
January 24, 1989

AGC is:

- More than 32,500 firms including 8,000 of America's leading general contracting firms responsible for the employment of 3,500,000-plus employees;
- 104 chapters nationwide;
- More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities.

The Associated General Contractors of America is a construction trade association representing more than 32,500 firms, including 8,000 of America's leading general contracting companies, which are responsible for the employment of more than 3,500,000 individuals. These member contractors perform more than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities. Eighty-five percent of AGC's membership has gross receipts of less than $10 million annually; ninety percent qualify under the Small Business Administration's definition of a small business. AGC appreciates this opportunity to comment on the new rules under Section 89 relating to employee benefit plans.

AGC strongly supports and endorses proposals that would delay implementation of the penalties under Section 89. If several important issues cannot be resolved, AGC supports repeal of the 1986 changes. The new rules do not further Congress' goal of encouraging broader coverage of nonhighly compensated workers. Instead, their complexity and administrative problems encourage employers to reduce the number of options they offer to employees.

Congress added new Section 89, setting up comprehensive nondiscrimination requirements for employee health and welfare benefit plans. Its goal was to encourage expanding health care coverage to more nonhighly compensated employees. The extreme complexity of the tests, the costly administrative burden they impose and the failure of the Internal Revenue Service to provide timely essential guidance is instead pushing small businesses to eliminating health care or reducing their health care coverage.

Congress added the new rules as part of the Tax Reform Act of 1986. Originally, the new law was to become effective for plan years beginning after December 31, 1987, if the IRS issued guidance. In the absence of IRS guidance, the new rules were then to become effective for the earlier of plan years beginning at lease three months after the regulations were issued or plan years beginning after December 31, 1988. As part of the 1988 tax act, Congress directed the IRS to issue guidance by November 15, 1988. Congress also legislatively prescribed some temporary rules to fill the void. To date, the IRS has not issued guidance on Section 89, even though the new rules have gone into effect.

The lack of guidance from the IRS is the most acute, though not the only, problem facing employers trying to comply with Sec. 89. IRS and Treasury representatives have said that there is sufficient guidance elsewhere in its releases for employers to comply with the new law. If that were true, then the IRS and Treasury should have found it relatively simple to provide guidance. Instead, more than two years after enactment, there is no official guidance on Section 89.

If the IRS and Treasury cannot provide guidance, then employers should not be expected to make up the deficiency. Employers making a good-faith effort to comply may find their determinations overturned on audit. Steep penalties would follow for failure to comply with Section 89.

In addition to the IRS' failure to provide timely guidance on the new law, AGC has identified several specific problem areas.

Some of the most acute problems center around the plan qualification requirements. Employers must first satisfy a five-part qualification test for employee benefit plans established under any one of nine different Internal Revenue Code sections. These include group health and accident plans, group term life insurance plans, group legal services plans, educational assistance plans, dependent care assistance plans, tuition reduction plans, cafeteria plans, Sec. 505 plans (including VEBAs) and employee fringe benefits plans.

For each of these plans, the plan must be in writing, the employees' rights must be legally enforceable, employees must be given reasonable notification of benefits, the plan must be established for the exclusive benefit of the employees, spouses and dependents, and the plan must be established with the intention of maintaining it for an indefinite period of time.

These requirements do not sound that difficult to meet. On closer examination, a number of problems appear.

For example, after the 1988 act, the written material describing the plan may be a group of documents, as long as each plan is adequately described in writing. If an employer provides a company cafeteria or allows employees to purchase books at a discount, those are plans that must be described in writing. If a construction company provides an on-site facility to take care of cuts or other injuries, that must be adequately described in a written plan.

Those plan documents must be legally enforceable. The employees' rights must be ascertainable from the documents, so that legal remedies can be pursued based on the documents. So those documents must be carefully prepared with that in mind, even though the employer has not received guidance on the contents of the documents.

Employees must receive reasonable notification of their benefits under the plan. What constitutes reasonable notification? The answer seems to be that every employee must be notified of every benefit under every plan, in order to avoid Section 89 penalties. Notification may not be limited to employees who are eligible for a particular benefit. On-site workers would be notified that there was a cafeteria in the head office. Secretaries would be notified that on-site workers could receive emergency care at an on-site facility.

Must each member of each collective bargaining unit be notified of benefits offered to all other units? If so, where would the information be obtained? Plan administrators are under no obligatio to provide it. At least one interpretation of the statute indicates that reasonable notification includes such notification.

The plans must be established for the exclusive benefit of employees, their spouses and dependents. There may be a hidden trap in that provision.

Congress concluded that employees of a leasing organization were to be treated as employees of the organization to which they provided services for retirement plan purposes in a number of situations. Congress later extended this rule to plans covered by Section 89.

The IRS published proposed regulations that broadly define a leasing organization far beyond Congress' intent. Some IRS representatives interpret the employee leasing rules to cover the general contractor-subcontractor relationship.

If the subcontractor's employees are to be treated as the general contractor's employees for Section 89 purposes, then the subcontractor's employees will have to be notified of the general contractor's plans. If the subcontractor's employees are not to be treated as the general contractor's employees, then including them may cause the plan to fail Sec. 89 because it is not for the exclusive benefit of employees. The general contractor may be caught in an impossible situation.

If a general contractor is too broadly inclusive, he may fail that part of the test. If he isn't inclusive enough, he will fail a different part of Section 89. If a construction contractor doesn't provide notice of his plans to his subcontractors, he may fail the qualification requirements if the IRS later determines he should have done so.

The issue is not academic. It is an issue the construction industry is struggling to resolve, because the penalties for noncompliance in this area are so severe.

Failure to meet even one of the qualification requirements would mean that all employees, from the lowest-paid to the highest-paid, must recognize additional income and pay taxes. For example, a general contractor may have a subcontractor for a specific project. At least some IRS representatives have indicated that the employees of the subcontractor would be treated as employees of the general contractor for purposes of Section 89. If the general contractor hasn't given the subcontractor's employees reasonable notification of the general contractor's health plans, all employees will then be faced with a large, unexpected and unpredictable tax bill. A number of them might even be faced with penalties for inadequate withholding. This is before any of the second part of Section 89 is even considered.

The qualification requirements ae only the first and allegedly the easiest step. Employers must then satisfy either a two-part actual coverage test or a four-part eligibility and benefits test for their group health and accident plans and group term life insurance plans. If those tests aren't satisfied, highly compensated employees will recognize income on the excess benefits.

These are a number of problems with this part of Section 89. The 1986 act set percentages that had to be met to satisfy Section 89's requirements. For small businesses, those percentages may be extremely difficult to meet. The loss or addition of just one employee may be enough to disqualify a plan.

The question of valuation of benefits is central to the entire Section 89 process. Employers have been struggling to define that concept until Congress legislatively prescribed some temporary special valuation rules. The absence of guidance on this most important issue would by itself be enough reason to postpone implementation of Section 89. Even the temporary rules do not resolve problems faced by employers.

The costs of compiling the initial information with which to begin Section 89 compliance are staggering. Employers must accumulate a significant amount of data regarding each employee and each option under a plan to prove compliance. The information required includes an employee's date of birth, the date of hire, marital status, employment status, number of dependents, annual compensation for this year and the preceding year, the number of hours normally worked in a week, the number of months normally worked in a year, whether employees are eligible members of a collective bargaining unit, benefit options an employee is eligible for, benefit options the employee actually participates in and other coverage on employees, spouses and dependents.

For example, each option under a plan must be valued separately. That means that for each option, each employee must be ranked twice - once under this year's salary and once under last year's - to determine how many highly compensated employees participate in that option. The confusion of an employer faced with calculating all options for all employees approaches chaos.

In an earlier example, the employees of a subcontractor were treated as employees of the general contractor for Section 89 purposes. The penalties for noncompliance would fall on the general contractor. Nowhere is there any mechanism for having the subcontractor supply the necessary information on to its employees.

A similar situation arises in multiemployer plans, of which approximately half involve the construction industry. An individual contributing employer bargains for a cents-per-hour contribution. The multiemployer plan administrator is responsible for plan design and administration. Plan administrators are not required to provide information to the employer. The employer has no way of knowing which employees are highly compensated. If a plan is discriminatory, an individual employer cannot take any steps to correct a problem. But the employer is faced with the noncompliance penalties.

The tax-favored treatment of employer-provided employee benefits reduces federal budget receipts. That treatment is justifiable because it furthers an important social goal of expanding health care coverage. The new Section 89 provisions will have the opposite effect on employers. The increased complexity, compliance costs, and the expensive necessary testing process will push employers to streamline their plans, reduce the number of options offered and cut back on health care coverage. Implementation of the statute needs to be postponed until it can be reexamined and the IRS prepares the essential guidance needed for compliance. If the issues cannot be resolved, Section 89 should be repealed.

SILVIO O. CONTE
First District, Massachusetts

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Opening Remarks
of the Honorable Silvio O. Conte
Hearing on Internal Revenue Code Section 89
January 25, 1989

Mr. Chairman, thank you for convening the second of hopefully a number of hearings to discuss the impact of Internal Revenue Code Section 89 on small business. Section 89 was part of the 1986 Tax Reform Act, P.L. 99-514. The intent was to extend/equalize health and life insurance benefits for all full-time employees. Section 89 was clarified by technical corrections in P.L. 100-647 but it still presents monumental problems for small businesses and their employees.

While I support the intent of Section 89 I do feel strongly that there should be further dialogue and analysis of its impact on small business. In order to do this I believe that we must repeal the law. Accordingly I have cosponsored legislation to just that.

It is said that the road to hell is paved with good intentions and this is a good example. I don't know whether the Ways and Means Committee viewed Section 89 as a source of revenue or as a back door form of mandated benefits - most likely both. But from the mail I've received and the comments at yesterday's hearing it appears that Section 89 will not help balance the budget nor will it provide coverage to the thirty-seven million uninsured/underinsured individuals in America. It will, however, undoubtedly exacerbate the problem by forcing small business to reduce or eliminate their coverage thereby placing the burden for coverage on the individual employee.

While there are enormous problems with the technical complexity of the bill there are several problems with Section 89 that need immediate attention. The January 1, 1989 effective date is unrealistic and no regulations have yet been promulgated. Absent repeal I strongly believe that Congress should, at the very least, amend the law to include it under the Regulatory Flexibility Act for promulgation of regulations.

Again while I support the noble goals of Section 89 I suggest no effective action can be taken to address this issue until we move to contain the rising costs of health and life insurance and include small business in all future policy/legislative actions affecting them.

I look forward to todays hearing and to the testimony of our distinguished panelists.

Statement of Paula Calimafde on Behalf of
The Small Business Council of America, Inc.
and The National Association of Women Business Owners
January 25, 1989

Mr. Chairman and members of the Committee, my name is Paula A. Calimafde. I am the President of the Small Business Council of America, (SBCA), a nonprofit, nonpartisan national organization which represents the interests of small business organizations on Federal tax matters. The Small Business Council is affiliated with the Small Business Legislative Council. I am also a member of the National Association of Women Business Owners (NAWBO), a trade association representing more than 2700 women-owned businesses around the country, with active chapters in 40 cities. NAWBO is affiliated with the Small Business Legislative Council and the Federation of Organizations for Professional Women. I also had the privilege of serving as a National Commissioner on Payroll Costs at the 1986 White House Conference on Small Business. Payroll Costs covered employee benefit and retirement plan issues. I am pleased to appear here today on behalf of NAWBO and the SBCA and to extend our support for the outright repeal or major simplification of Section 89.

The Office of Advocacy of the U.S. Small Business Administration (SBA) has been actively monitoring the impact of Section 89 on small business and how this new tax section may affect the ability of small business to deliver health care to its employees. The SBA is also pursuing viable alternatives to Section 89. I have had the opportunity to engage in a dialogue with the SBA on Section 89 and can strongly support their work and views in this area. To this end I would like to refer to a letter from James Abdnor, the Administrator of the SBA to Nicholas Brady, the Secretary of the Treasury dated January 4, 1989. In part this letter states: "The burdensome Section 89 requirements will further deter small employers from initiating or maintaining health benefit plans by adding considerably to the expense needed to provide those plans. Additionally, small employers will incur this expense without regulatory assurance that they have followed the dictates of the law. At a time when Federal policy is properly focusing on expanding and encouraging voluntary health care coverage, and all employers face soaring health care costs, federal action which would discourage employer provision of health coverage must be avoided."

BACKGROUND Section 89 is a provision of the Internal Revenue Code added by the Tax Reform Act of 1986 ("TRA 86"). It applies new qualification rules to accident and health plans, group term life plans, dependent care plans, tuition reduction plans, cafeteria plans, certain fringe benefit plans, such as employee discounts and VEBA's. It also applies detailed nondiscrimination rules to some of these employer-sponsored welfare benefit plans, in particular health care coverage and group-term life insurance. Prior to TRA '86, all qualified retirement and capital accumulation plans were subject to discrimination rules. Insured medical benefits were not subject to discrimination rules unless they were under welfare benefit plans. Approximately 22 million employees in the United States have direct employer-provided health plans.

The purpose of these rules are two-fold. First, the purpose of the qualification requirements are to ensure that employees who are provided certain benefits by their employers have a reasonable notification of the benefits for which they are eligible and have a legally enforceable right to such benefits. Secondly, the nondiscrimination rules will measure whether employer sponsored benefits are fairly distributed. Inherent in the concept of "fairly distributed" is the view that the tax-favored benefits available to highly compensated employees should not be significantly more valuable than benefits provided to non-highly compensated employees. If the employee benefit plan fails the discrimination tests, the higher paid employees are taxed on the benefits that exceed the section 89 limits. The social policy objective justifying the exclusion from income of employer provided welfare benefits is the receipt by low and moderate income employees of certain social services, i.e., medical benefits.

Fairness in actual receipt of benefits by non-highly compensated employees at the distribution point is the goal of the legislation, rather than assuring non-discriminatory availability. However, by relying, in part, on actual "receipt" of benefits for the test (rather than mere eligibility), employee choice can affect whether or not the plans pass the discrimination tests. And for small business, where 14 percent of employees who are offered health benefits decline coverage, it can be key to having nondiscriminatory plans.

Our emphasis in this testimony will be on health plans, which are subject to the discrimination rules. Life insurance plans also require mandatory testing. An employer can elect to have other so-called "statutory employee benefits plans" tested under Section 89 as well.

In addition to discrimination testing, Section 89 requires all employee benefit plans to pass the qualification requirements of Section 89(k). The qualification requirements will be dealt with later in this paper, but their importance cannot be overestimated. However, we have singled out the health care issue because it is a national concern, particularly because of the large number of working employees who are uninsured in small businesses. We believe that the requirements of Section 89 along with the increasing pressure of escalating health care costs, will deter small employers from providing additional health care coverage and/or cost containment options.

QUALIFICATION REQUIREMENTS Under the qualification requirements encompassed in Section 89(k), a broad range of employee welfare and fringe benefit plans will have to be in writing; provide employees with legally enforceable rights; be for the exclusive benefit of employees; be of indefinite duration; and be communicated to employees. The law requires most of these requirements to be met by the first day of the first plan year beginning in 1989. Only the written plan requirement can be met as of the last day of the plan year. However, no regulatory guidance informing employers how to meet these requirements has been published even though we are now almost into the second month of 1989.

DISCRIMINATION TESTS Section 89 does not outlaw discriminatory plans; it taxes compensation above the discriminatory level. To reach this goal, Congress has instituted a maze of interrelationships that must be assembled in order to test for nondiscrimination.

There are four primary tests. Each group life or health plan must satisfy either two eligibility and one benefits test or an actual coverage test. However under either alternative, an additional test, referred to as the non-discriminatory provision test, must be satisfied. Since this test requires no complex calculations but merely requires that no plan provision discriminate in operation in favor of highly compensated employees, we will ignore it for purposes of this testimony.

Under the first of the eligibility and benefits tests, 50 percent of the employees eligible to participate in the plan must be non-highly compensated employees (NHCE). This is referred to as the 50% eligibility test. This test is not a test looking at actual coverage. Next, 90 percent of the NHCE's eligible under the plan, must have available a benefit that is at least 50 percent as valuable as the largest benefit provided to any HCE under the plan. This is often referred to as the 90%/50% availability test. Third, the average employer-provided benefit actually provided to NHCE's under the plan must be at least 75 percent of the average employer provided benefit actually provided to HCE's. This is referred to as the 75% benefits test.

Alternatively, an employer can satisfy the tests if he can show that 80% of his non-highly compensated employees are actually covered under the plan. This test was designed to be a simple alternative for employers who have a relatively simple benefit structure. Because the 80% coverage test is applied on a plan by plan basis (rather than to all plans of the same type) it is not likely to be useful to employers maintaining more than one plan unless those plans can be treated as "comparable". Comparability for these purposes, is a term of art defined in Section 89. While the Technical and Miscellaneous Revenue Act significantly relaxed the comparability standards by enacting numerous safe harbors, applying the safe harbors requires numerous hours of mental gymnastics because of the complexity of these provisions.

While I have only just briefly touched on the broader elements of these tests, the complexity of tests, as you can see, cannot be overestimated. In addition, to the tests themselves, there are permissive aggregation rules, mandatory aggregation rules, disaggregation rules, and safe harbors which are unique to this new welfare benefit plan testing area, as well as a number of rules and concepts borrowed from the pension area covering among other things, controlled groups of employees, leased employees, and highly compensated employees. The highly complex structure of the new rules are enough to discourage benefit practitioners, let alone small business owners.

Additionally, there are even more basic elements in the application of the tests that must be considered. And unfortunately, the Treasury Regulations which would instruct employers as to the application of these more basic elements are not yet published.

1. Family Coverage The treatment of family coverage is very important to small business because data shows that more workers in firms with under 500 employees are covered by someone else's private health insurance as compared to workers in firms with over 500 employees. Sworn statements can be used to exclude employees under both the 80% coverage test and the benefits test as long as they are covered elsewhere and have core benefits under the other plan. But, they must be entitled to elect health coverage as if it were open season if such other coverage ceases.

Sworn statements need to be collected no more frequently than every three years, unless employees make elections more frequently. They must include information on the actual coverage a person is receiving as well as information regarding coverage and family status.

2. Time for Testing While Section 89 as initially enacted required employee benefit plans subject to its requirements to be in compliance and perform testing based on the first plan year beginning after December 31, 1988, the Technical And Miscellaneous Revenue Act of 1988 ("TAMRA") adopted new "testing year" and "testing date" concepts. However, the plan

year concept was not eliminated so that now employers have three concepts to apply rather than the initial one or latter two.

Pursuant to TAMRA, an employer may now designate a common 12 month period as the "testing year" for all plans of the same type (receiving tax exclusions under the same Code Section). After 1989, Treasury must consent to any change in the testing year.

In addition, rather than testing on each day of the plan year as originally required, the tests now are generally applied on the basis of benefits provided on one day of the testing year. This day must be the same for all plans of the same type in the unit being tested. Again, after, 1989, Treasury must consent to any change in the year.

However, data as of the testing date must be adjusted to take into account all mid-year election changes by HCE's as well as midyear plan design changes which affect plan valuation or the enrollment status of any employee. Thus, because of the adjustments which are required in these instances, the concept of a "snap-shot photo" testing date is somewhat illusory.

3. What data is required to be gathered to run the tests?

A. The number of highly compensated employees for both the current and prior years; employees who have separated form service due to retirement or disability are to be tested separately (essentially, to test highly compensated retirees);
B. The number of nonhighly compensated employees;
C. Excludable employees;
D. Employees and family members with other group coverage;
E. The number of part-time employees and hours worked each week;
F. The number of former employees in employee benefit plans;
G. The number of employees by highly and nonhighly compensated

type, covered under each plan;

H. The number of employees with families enrolled in family coverage;

I. Employee specific information to track benefits offered and provided to each employee under each employer plan.

J. Number of separate health plans per line of business;

K. Description of and values for each separate benefit plan (Under the Act, the Secretary is to prescribe rules regarding valuation of benefits, and until that time, employers can use actual plan costs or actuarially determined values for health plans or the Consolidated Omnibus Budget Reconciliation Act ("COBRA") valuation tables.);

L. Evidence that each plan is in writing and that proper notice has been provided to employees and the government;

M. Employer and employee contribution structures for each plan;

N. Actual employer cost and employee cost for each separate plan.

PENALTIES If the employer fails the non-discrimination tests, income must be imputed to the highly compensated employees. This "discriminatory excess" is the amount by which an HCE's employer-provided benefits, (which includes benefits provided through elective contributions), exceeds the highest permitted benefits under the plan.

The computation is such that highly compensated employees peel back their benefits to the point at which the health plans pass the tests. Once the amount is assessed, income is imputed to the highly compensated employees. The actual mechanics are, of course, more complicated than this explanation, but this is basically how the additional income is computed.

On the other hand, if the employer fails any of the 5 basic qualification requirements (that the plan be in writing, legally enforceable, employees notified of benefits under the plan, maintained for the exclusive benefit of employees, and established with the intent of being continued indefinitely), then each employee has to include the total value of his or her employer-provided benefit in gross income. For a staff employee who underwent open-heart surgery during the plan year and had costs reimbursed by an employer-provided health insurance, the employee could be facing literally hundreds of thousands of dollars in additional income if the employer failed to properly "qualify" the plan under Section 89. Clearly, the employee has no control over the actions of the employer in this regard and yet can face substantial amounts of "phantom" income with no source for the payment of taxes. This problem is particularly acute since many small businesses may still not even be aware of Section 89 and the Government is not getting the necessary information out to the public. A simple example can illustrate the extent of the problem facing all businesses, but in particular, small businesses. Section 89 today requires that businesses notify their employees of the benefits provided under the employee benefit plans covered by Section 89. This notice is required to be given the first day of the Plan Year. Within the last three months, a Treasury spokesman at a professional benefits luncheon told those present (and the press) that the notice requirement would be postponed until the last day of the first calendar quarter or the first day of the plan year, whichever occurred later. Recently, at another employee benefits conference, another Treasury spokesman, stated that the notice requirement would be further postponed until July 1st, 1989 or the first day of the plan year, whichever occurs later. Now this is confusing enough for an employee benefits expert who practices in Washington, DC, but for the small business owner in Billings, Montana who sees his or her accountant once or twice a year, this is an impossible situation. Worse, if the Proposed Regulations do not in fact postpone the date of the Notice requirement, then many business are likely to already be in violation of the qualification requirements of Section 89.

An employer's failure to report the discriminatory excess as W-2 income leads to the imposition of an excise tax on the employer equal to the highest rate of tax imposed by Code Section 1 multiplied by the employer-provided benefit with respect to the employee or employees to whom the failure relates. This tax is not deductible and may not be offset by credits or other deductions.

EFFECT OF SECTION 89 1. All employers are confused about Section 89, including timing requirements and penalties. Thus, higher administrative costs, both internally and for professional services, are inevitable. As you can tell by the requirements set forth above, the information required for testing is neither normally collected, nor readily accessible. Also, the language used in the statute does not correspond to the generic use of terms such as "nondiscrimination" and "plan". This is particularly confusing to small employers who do not readily engage consultants and attorneys.

2. The response by employers -- that we are already seeing--

may be, in some instances, to eliminate employer-provided health coverage altogether, or alternatively, to limit their plans by eliminating subsidized family coverage; reducing available health options; and eliminating plan choices for employees.

3. It is especially noteworthy that in numerous instances, Section 89 can essentially tax employees on the value of benefits received from an employer, where factors totally within the control of the employee determines whether or not the employer's plans will pass the various tests under the sections. The smaller the testing group, the easier it is for this to happen.

4. The fact that small business has higher per capita premium costs; higher employee turnover rates and greater use of part-time employees increases administrative costs for small firms relative to large firms. These characteristics complicate the application of Section 89, and increase administrative burdens and costs.

5. Future innovative efforts in plan design will be affected by rising health care costs and the need to carefully manage them, and new government regulations such as Section 89.

6. The request for a delay in the application of penalties is necessary because the technical corrections standard of "good faith compliance" does not go far enough. This area is so confusing, and the penalties heavy enough and cost of compliance significant enough, that an overall delay is required.

7. Technical Corrections did provide more latitude for small employer testing; however, even with these changes, Section 89

does not encourage dependent coverage for small plans, and the lack of dependent coverage in employer-provided health plans is a major point in the debate on the uninsured. It seems that this type of complicated testing whereby an employer can comply one year and fail the next without having changed anything substantial in the plan encourages nothing more than basic, single coverage or no coverage at all; especially if the employer believes that its chances of compliance are too close to call.

8. Selection of benefits may not be the key to delivery of comparable benefits. If employees value a certain benefit package over another, which may change at various times in their lives, the dollar value may not be comparable. If the employee has the opportunity to choose among benefit options, it seems that comparability and availability have been met, and no highly compensated employee should have to recognize additional income. This result does not appear to be a given since the maze of new aggregation tests will take some time to apply to any given situation to determine whether in fact the plan is discriminatory or not.

9. The 80% coverage test which began as a relatively simple but extremely restrictive alternative to the eligibility and benefits tests has through the use of numerous safe-harbors enacted under TAMRA expanded the opportunity to aggregate so-called "comparable plans". However, the safe harbors enacted to relax the comparability requirements are themselves so complex that it takes numerous hours to understand and apply them. Perhaps

additional consideration needs to be given to this test and safe harbors to not only broaden its application but to also simplify its provisions.

CONCLUSION

In summary, the repeal or major simplification of Section 89 should be undertaken by Congress. Because of the significant complexity of the statute, the lack of experts in the country on this Code Section, the draconian penalties imposed on employees with no culpability on their part, and the lack of information disseminated to the public by the government on Section 89, it is highly desirable for repeal or at a minimum, significant delay in the effective date of the statute. Absent outright repeal or total postponement of the statute for at least one year, SBCA and NAWBO call for the following:

o All penalties be delayed for at least one year; the penalty imposed on employees due to lack of plan qualification on the part of the employer be eliminated entirely;

o A six month relief period be granted whereby employers can properly collect the necessary employee data and determine how best to structure the company's benefit plan structure in order to reduce administrative burdens under section 89 - that is any plan changes made during this six month period not be taken into account under Section 89;

o A study to be undertaken to see if the discrimination rules can be streamlined and brought more into line with the rules governing qualified retirement plans (eg. utilizing a 20 hour standard for part time employees rather than a 17 1/2 hour standard);

- The earliest effective date of any section of the law be postponed until six months after the Treasury issues Proposed Regulations so that the public has sufficient time to garner the necessary guidance to properly implement the statute.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

January 4, 1989

Honorable Nicholas Brady
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Secretary Brady:

On January 1, 1989, Internal Revenue Code Section 89 standards governing tax qualification of certain employer provided fringe benefits became effective. This law is complex, the standards are new and the details are largely undefined by regulation. You would advance good fringe benefits policies by announcing a delay in enforcement of this section. The Department must simplify the nondiscrimination rules and expedite the issuance of guidance on their application.

Access to affordable health care by employees of small businesses is necessary if we are to reduce the number of uninsured Americans. According to research performed for the Small Business Administration Office of Advocacy, most of the working uninsured are found in small firms. These firms are less likely to offer health coverage because they incur higher premium and fixed costs, experience more frequent employee turnover and more often utilize part-time and seasonal employees. The burdensome Section 89 requirements will further deter small employers from initiating or maintaining health benefit plans by adding considerably to the expense needed to provide those plans. Additionally, small employers will incur this expense without regulatory assurance that they have followed the dictates of the law. At a time when Federal policy is properly focusing on expanding and encouraging voluntary health care coverage, and all employers face soaring health care costs, federal action which would discourage employer provision of health coverage must be avoided.

As you know, Section 89 is intended to ensure that businesses do not discriminate in favor of highly compensated employees. It attempts to effect this policy, however, through an exceedingly complex set of tests which require employers to collect and maintain extensive information on workers, plan coverage provisions, and workers' benefits eligibilities, and sanctions noncompliance with onerous penalties. To date, there is no formal guidance from the Internal Revenue Service on the implementation of the tests required for employee benefit plans under the Tax Reform Act of 1986. There is also a lack of guidance from the Department of Treasury under the Technical and Miscellaneous Revenue Act of 1988 on how businesses are to comply with Section 89's requirements. The essential purpose of Section 89 can only be accomplished if the rules which seek to effect proper distribution of benefits are implemented in a manner which does not discourage the establishment and continuation of employer-provided benefits.

We urge the Department of Treasury to afford small employers this necessary relief, in order to promote greater access to affordable health care plans by all employees. We are ready to work with you to accomplish this important objective.

Sincerely,

James Abdnor

James Abdnor
Administrator

APPWP
Association of Private Pension and Welfare Plans

Statement of

The Association of Private Pension and Welfare Plans

Before the

Small Business Committee

On

"Internal Revenue Code Section 89, Employee Benefits"

Tuesday, January 24, 1989

Washington, D.C.

Howard C. Weizmann
Witness
Executive Director, APPWP

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SUMMARY OF STATEMENT OF HOWARD C. WEIZMANN, EXECUTIVE DIRECTOR OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS BEFORE THE SMALL BUSINESS COMMITTEE, U.S. HOUSE OF REPRESENTATIVES ON "INTERNAL REVENUE CODE SECTION 89, EMPLOYER BENEFIT NONDISCRIMINATION RULES"

As a former benefits manager and the Executive Director of the APPWP, a nonprofit organization founded in 1967 to protect and foster the growth of this country's private employer-sponsored employee benefit system, I am pleased to speak on an issue that is of such great concern to our over 400 employer, benefit consultant, banking and insurance members. We commend the Committee for holding hearings on an issue of such great importance to all employers, large and small.

Section 89 of the Internal Revenue Code is a far-reaching statute ostensibly designed to insure that the tax subsidies associated with non-retirement employee welfare-benefits -- such as health care and employer-provided group life insurance -- are not provided on a basis that discriminates in favor of Highly Compensated Employees, essentially the top-earning twenty-percent of employees with earnings in excess of $50,000 ("HCE's").

The APPWP opposes Section 89 in its present form for three reasons:

1. The statute is overly complex, requiring all employers large and small, private and public, profit-making and nonprofit, to comply with a set of requirements that are so complex that even the Treasury Department has yet to issue regulations more than two years after the statute was passed. The enormous expense for both small and large employers required just to determine compliance is out of line with the benefit produced. For example, one consultant for small employers cites a typical example of a company with fewer than 50 employees spending $60,000 in administrative fees to determine $4,000 worth of imputed income to HCE's.

2. The goals of the statute -- increased tax equity and efficiency and health care coverage -- are not attainable, as the law is now drafted, because the statute cannot be reasonably complied with and enforced. As a result, it will be more economically feasible for employers to refuse to apply the law and simply impute income to HCE's.

3. Section 89 will have an adverse impact on health care delivery. At a time when the issue of 37 million uninsured is being debated and health care inflation is approaching double digits, Section 89 will promote a reduction in coverage among those who find it cheaper to pay higher salaries to formerly covered employees than to extend coverage. It will also dampen efforts to find cost-effective alternatives to control the cost of health care.

We will be happy to work with all interested parties to refine and simplify Section 89 so that it attains reasonable tax and health care coverage policy goals.

I am pleased to be able to come before you today on behalf of the Association of Private Pension and Welfare Plans (the "APPWP") to discuss the issues raised by Section 89 of the Internal Revenue Code. The APPWP is a nonprofit organization founded in 1967 to protect and foster the growth of this country's private employer-sponsored employee benefit system. As Executive Director, I speak on behalf of the APPWP's over 400 members, which include both large and small plan sponsors as well as employee benefit plan support organizations such as investment, banking, insurance, actuarial, legal, and consulting firms and other benefits professionals. As a former manager of benefits planning for a large employer (and as a director of a small association with eight employees), I am particularly gratified to have the opportunity to address an issue that more than any other in recent memory has left the business community with a sense of outrage and exasperation. We wish to commend this Committee for holding hearings on an issue of such pressing concern to all employers large and small.

Section 89 of the Internal Revenue Code, as passed by the Tax Reform Act of 1986 ("TRA '86") and as recently amended by the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), is a far-reaching statute, ostensibly designed to insure that the tax subsidies associated with non-retirement employee welfare benefits -- such as health care and employer-provided group life insurance -- are not provided on a basis that discriminates in favor of highly compensated employees ("HCE's"). More specifically, Section 89 provides a series of tests to determine if a plan is discriminatory. If a plan is found under these tests to discriminate, the value of the "discriminatory excess" must be taken into income by the HCE's who participate under the plan.

In addition to the nondiscrimination requirements, Section 89(k) contains plan qualification requirements and provides additional penalties if these requirements are not met. Although the Section 89(k) requirements are not the subject of these comments, I would just like to note two points. First, despite the fact that the notice requirements of Section 89(k) apply as of January 1, 1989, the Treasury Department ("Treasury") has yet to issue regulations clarifying their scope, making compliance difficult, if not impossible. Second, this lack of guidance will not only adversely affect plan sponsors and HCE's, but precisely those employees it was designed to assist, since the penalty provided under Section 89(k) requires all participants -- not just the HCE's -- to include the total value of benefits received under the plan in income. (A more detailed description of the requirements of Section 89 is attached.)

At the time Section 89 was passed, it went relatively unnoticed, contained, as it was, among the sweeping employee benefit provisions of TRA '86, many of which were effective long before the effective date of Section 89. However, even as employers were wrestling with major modifications to Section 401(k) retirement plans, COBRA continuation of health coverage requirements and other provisions which had a more immediate impact on employee benefit plans, they began to anticipate the impact that Section 89 would have on non-retirement benefits as they exist today. As early as 1987, a group of concerned employers, providers, consultants and associations began meeting to try to identify specific problems in the statute and to seek legislative and regulatory relief and clarification.

So, what's the problem with Section 89? The response is threefold: the statute is overly complicated; the goals of the statute are not attainable as the statute is currently drafted; and many feel Section 89 will have an unintended and adverse impact on the health care system as it exists today. Let me review these issues in more detail.

1. The Statute is Overly Complicated

A simple review of the statute's requirements as they apply to all employers -- large and small -- will give you an idea of just how complex Section 89 is.

The scope of Section 89 is enormous. In addition to applying to all private employers, regardless of size, Section 89 requires compliance by federal, state and local governments and nonprofit organizations, including universities, hospitals, etc. This is not to suggest that Section 89 could be corrected by simply exempting one group or another. All of these entities suffer from the same problems under the statute, and, as such, statutory changes should be applied fairly across the board. Instead, Section 89's scope begs the question as to whether and where actual discrimination exists. Section 89 was enacted without Congressional fact-finding as to whether employers as a whole discriminate, and, if so, to what extent. Moreover, Congress failed to determine whether differences in coverage between HCE's and non-HCE's are the result of employer discrimination or employee choice. Many in the benefits area maintain that most differences in coverage are attributable to the latter and reflect the legitimate differences in the health care needs of different individuals. To get around the lack of any precise data concerning these issues, Congress simply enacted Section 89, placing on employers the burden of proving nondiscrimination.

To satisfy their burden, employers must first identify every coverage option that is offered to any employee. This includes all single and family coverage options, all employee contribution and coverage levels, all health and certain other options under flexible benefit plans and each separate HMO, Preferred Provider Organization or other managed care system. Among large employers, this means that data must be collected on literally hundreds of different plans, as well as on the participants in such plans. One typical employer reported that, for Section 89 purposes, over 550 different options or "plans" must be tested for compliance under Section 89. Based on a survey conducted by the APPWP last spring, most employers responded that Section 89 required the additional testing of at least three to four times as many options as there were plans. For a company with multiple payroll and benefit systems and numerous geographic locations, which may participate in some 40 or 50 different HMO's, the enormity of simply determining this initial step of compliance is astounding. Even for a small employer, Section 89 requires sworn affidavits from employees of other coverages, complex determinations regarding which plans are subject to what tests, the status of employees, whether part-time employees or leased employees, etc.

Next, employers must determine which employees are to be included in the test and which employees are highly compensated. This requires determining the financial and marital status of all employees, establishing tracking systems to determine hours worked by part-time employees, gathering individual sworn statements from employees as to whether they have a spouse and dependents and whether they are covered by a spouse's plan in another company, determining the status and coverage of leased employees, and comparing the minimum age and service participation requirements under all plans of the employer. Even though data systems for most large companies are decentralized and benefit systems are fragmented, employers must first determine whether they pass Section 89 on a company-wide controlled group basis before determining whether they need to redefine testing based on separate lines of business (the definition of which has not yet been elucidated by regulations).

Regrettably, the quality of the data collected is suspect in both the large and small employer context. Employees are not generally very forthcoming with information relating to coverage under other plans. This stems from an assertion of privacy rights as well as a well-founded concern that such data is used to coordinate benefit coverage with other coverage for which the employee may be eligible. For example, one Blue

Cross/Blue Shield official indicated to me that about 23 percent of all responses to a Section 89 census request were inconsistent with responses previously on file. While employers may reasonably rely on sworn statements as evidencing coverage, a statement indicating that no other coverage exists may unfairly skew the test toward a discriminatory result.

As complicated as the data collection problems are with respect to current employees, Section 89 also applies to former employees. Although Congress recently purported to exempt from Section 89's testing requirements employees who separated from service prior to January 1, 1989, the exemption is so riddled with caveats that many employers will be forced to track employer-provided benefits for all former employees forever. Moreover, there is no guidance as to how to test those former employees who terminated after 1988. For example, it is unknown whether employers may limit Section 89 testing to retired employees or must include in their testing all former employees. Finally, there is no clear guidance on how to identify which former employees are highly compensated.

Once employers have collected the data, they must test each separate plan option offered to current and former employees. They must determine which plans will be tested as part of a separate line of business and which options in each business can be combined under the numerous and highly complex comparability rules of the statute. Next, Section 89's numerical tests must be applied to the data. Although statistical sampling is theoretically authorized, its use will be greatly limited in practice by the stringent requirements imposed by Congress. Just in case the three different numerical tests required by Section 89 (see attachment) do not trip you up (recognizing that the 80 percent safe-harbor test contained in the statute will not be available to most employers), Section 89 contains a facts and circumstances test. Under this test, a plan that passes all the mathematical tests can still fail if it contains any provision relating to eligibility to participate which, by its terms or otherwise, discriminates in favor of HCE's.

In its recent amendments to Section 89, Congress added another purported simplifier -- testing on one testing day during the testing year. All plans of the same type, such as all health plans, must be tested on the same day, even if traditionally certain plans of the employer have had different open season periods, for example. In addition, the one testing day rule is substantially nullified by the requirement to take into account 1) changes that occur before or after the testing date in either benefits provided to or elected by HCE's, and 2) changes that occur after the testing date in benefits provided to non-HCE's. These exceptions will create severe record-keeping and computational problems for many employers.

Where the option or combined options being tested do not pass all the applicable tests, the value of the excess benefits must be calculated and income must then be imputed to certain highly compensated individuals who receive benefits under the plans. The calculations must be completed by the time W-2 forms are distributed, unless the employer is willing to defer his deduction until the following year.

The sheer cost of testing to many employers is staggering, particularly when compared to the benefits to be achieved. For large employers who generally have some benefits expertise on staff, the start-up costs of Section 89, mostly due to data collection, are estimated in the hundreds of thousands of dollars, with significant continuing expenses expected. In the small employer context, where benefits expertise must be purchased from outside consultants, the cost of compliance too will be dramatic. One consultant for small employers cited to me the example of a client with fewer than 50 employees who paid $60,000 to impute $4,000 worth of income to its HCE's.

The complications of Section 89 have been aggravated, as noted above, by the inability of Treasury to issue regulations to provide guidance to employers on how to comply with Section 89. Despite the two-year delay in the effective date of the statute in TRA '86 and the explicit direction by Congress in TAMRA to issue regulations by November 15, 1988, employers have been forced to cross over the threshold of the January 1, 1989 effective date with no view from Treasury as to how to comply with the statute. While we expect Treasury will eventually issue regulations, it will mean that many decisions that employers have made early in order to determine compliance by the end of the year will have to be undone when Treasury states its definitive views. Is this any way to run a government?

2. The Objectives of the Statute are not Reasonably Attainable

As noted, the premise upon which all of these objectives are based is that in order to qualify for the tax "subsidy," an employer may not discriminate in favor of its HCE's. Virtually no one disputes that this is an appropriate goal of a tax statute. In the pension area, nondiscrimination principles have long since been incorporated into the law with great success.

Section 89 goes about the business of insuring nondiscrimination by applying three distinct principles. First, it seeks to prevent discrimination through the control of plans available only to top company executives. Second, Section 89 seeks to extend coverage by requiring that specific percentages of non-HCE's be covered under plans maintained by employers. Third, Section 89 attempts to insure "tax efficiency" of the revenue expenditure provided by requiring that the benefits actually received by non-HCE's are close in value to those provided to HCE's.

All of this makes great sense, so where's the rub? The fundamental notion upon which the statute rests is that the imputation of relatively small amounts of income to individual HCE's, individuals who, by definition, can afford it, is somehow worth all that Section 89 requires you to do. Simply put, is tax efficiency promoted when the statute is, by everyone's account, so complex that Treasury is having great difficulty issuing regulations and when compliance for large and small employers and governmental and private plan sponsors is so difficult and expensive that a large proportion of these employers will simply ignore the statute rather than comply, or cause their employees to pay tax without ever making the expensive determinations required by Section 89? Moreover, enforcing the statute will itself be a nightmare. Does anyone really believe that IRS audit procedures under Section 89 will go beyond a simple examination of the testing percentages?

One case in point is illustrative of the dangers of searching for the Holy Grail of nondiscrimination. One of our member employers related a story concerning Section 89 compliance. As originally contemplated, Section 89 was to include an objective table which would allow employers to determine the value of their plans without having to resort to gathering data on the cost of plans. Basing value on costs is problematic due to geographical and utilization differences. (One Congressional staff person involved directly with Section 89 conceded that Section 89 could not work in the absence of such a table.) As an aid to Treasury in developing this table, the American Academy of Actuaries ("AAA") submitted a 40-page table which could be used as the basis for the Treasury table. Our employer member did some preliminary testing under Section 89 using both a cost approach and the AAA table. Under the cost approach, the company failed; under the AAA approach, the member passed. It is unclear whether this employer discriminates in favor of HCE's or not.

While some proponents of Section 89 declare that they are indifferent to whether employers seek to comply with Section

89, since they are only setting standards by which the tax "subsidy" can be earned, others attempt to justify Section 89 on the ground that it will actually change employers' behavior. Thus, they cite time and again evidence of lack of health care coverage among employers, even though 85 to 90 percent of the active workforce is covered by employer-sponsored plans, or the fact that many employers share a reasonable proportion of the cost of coverage with their employees as evidence of discrimination, when many younger employees decline coverage because they would rather have cash than insurance.

But even accepting these arguments, will the imputation of $1,000, $2,000 or even $3,000 cause employers to end discrimination under the statute? Will the imputation of income cause employers to extend coverage to part-time employees? In speaking with a broad cross-section of employers from coast to coast, the answer to these questions is a resounding "no."

In sum, if the argument is that the statute is simply promoting tax efficiency, the statute must be crafted so that it can be reasonably complied with and enforced. If the argument is that the statute is a social instrument, seeking to induce positive changes in the provision of health care and other non-retirement benefits, then we need only do a simple cost-benefit analysis to determine that it, in effect, will not achieve its desired ends. There is a better, simpler way to achieve the desired ends.

3. Section 89 Will Have an Adverse Impact on Health Care

As employers wrestle with Section 89 compliance, Congress is engaged in a monumental debate which will determine the fate of 37 million individuals who have no health insurance, a serious issue which this Committee studied in-depth last year and about which we applaud your recommended solutions.

Unfortunately, while we should be encouraging more small firms to provide coverage for their employees, employers are being directed in exactly the opposite direction by the tax policy underlying Section 89. The rules discourage the growth of employer-sponsored health benefits by creating an additional burden and cost for those employers considering offering health benefits. Some employers will find it cheaper to impute taxable income to themselves and eliminate the high cost of additional coverage and compliance with Section 89, thereby undermining the ostensible purpose of the statute. Employers trying to develop alternative delivery systems more responsive to the needs of their employees, such as HMO's and PPO's, and to expand options for employees to manage costs and use health care more wisely, are instead being forced to return to the days of a single, inefficient and enormously costly plan fully subsidized by the employer, or to no plan at all!

Moreover, the redefinition of part-time employees to include, for purposes of the tests, those employees who work more than 17.5 hours per week discourages the use of part-time employees. One typical story was related to me by a small business owner whose business depended on the use of part-time data entry personnel. Rather than expand health care coverage to part-time employees or hire a consultant to tell her how to comply with the statute -- options she could not afford -- she would limit the use of part-time employees to 17 hours per week. Can the health care delivery system afford these kinds of decisions resulting from Section 89.

4. Alternative Approaches

We agree with many of those who say that Section 89 needs to be significantly revised. We have repeatedly called for rules which should greatly simplify the nondiscrimination rules. For example, we would recommend that the nondiscrimination rules be refocused to apply primarily in those situations where employers have in effect structured their plans so as to exclude those who are non-HCE's, the so called "executive only" plans. A more appropriately focused Section 89 could also include other, simpler rules, based upon plan design instead of data collection, which would promote both compliance and policy objectives.

5. Conclusion

In conclusion, out of respect for those in government who have expressed a desire to make Section 89 workable, we will continue to participate in discussions concerning Section 89, in the hope that it will evolve in the direction outlined above. However, we recognize that in the end it may not prove possible to strike a balance between tax policy and health policy objectives on the one hand, and nominal tax equity and ease of administration on the other. When and if that time comes, and we hope it never does, we reserve the right to join many of those who today are urging repeal of Section 89.

APPWP
Association of Private Pension and Welfare Plans

FACTS ABOUT SECTION 89

THE BASICS

What is section 89? It's a section of the Internal Revenue Code added by the Tax Reform Act of 1986. It applies qualification requirements and a series of tests to employer-sponsored benefit plans, such as health and life insurance, in order to qualify the plans for certain tax benefits.

What Plans And Employers Are Affected? Non-pension benefit plans, particularly health and life insurance plans, are covered. The rules apply to all types and sizes of employers, including govermental units such as states and cities, non-profit organizations such as schools and hospitals as well as businesses of all sizes. Tests are run on a controlled group basis unless parts of the group qualify as "separate lines of business" or "separate operating units" which can be tested separately.

What Does Section 89 Do? First, Section 89 sets up basic rules for plan "qualification". Then it requires employers to apply a series of complex, quantitative tests to their benefit plans. This involves determining the value of each available option under every plan, determining which employees are eligible for and which are covered by each option and then applying the quantitative tests to that data. The tests attempt to measure whether the benefits are reasonably distributed between higher and lower paid employees.

Who Must Be Included In the Tests? In general, the tests include all employees except those: under age 21; OR with less than one year of service (six months for testing health benefits); OR working less than 17 1/2 hours per week; OR working seasonally (less than six months per year); OR who are nonresident aliens. However, employers must include all employees from any above group if any member of the group is eligible for a plan of the type being tested. Bargaining unit members may be excluded only if no employee in the unit is eligible for any employer-paid benefit of the type being tested. Retirees and other former employees with benefits must be tested. Benefits for dependents are also tested. For those tests, employers may exclude employees without dependents or whose dependents have other health coverage if such employees provide sworn statements as to the absence of dependents or presence of other coverage.

What Happens If Plans Fail The Tests? If a plan fails the qualification tests, all benefits paid from the plan (e.g., hospital expense payments) become taxable income to the employees receiving such benefits. Under plans which fail the nondiscrimination tests, the value of any "excess benefits" for higher paid employees is included in those employees' taxable income.

When Is Section 89 Effective? It generally becomes effective for plan years beginning on or after January 1, 1989.

SOME DEFINITIONS

To apply the section 89 tests, these terms need to be defined:

Highly Compensated Employee (HCE) is an employee who, in the current or preceding plan year: owned 5% or more of company stock OR earned more than $75,000 per year OR earned more than $50,000 & was among highest paid 20% of all employees (determined on a controlled group basis without regard to lines of business) OR was an officer and earned more than 150% of the amount defined in Code section 415.

Non-Highly Compensated Employee (NHCE) means any other employee.

(over)

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Benefits are employer-paid amounts (i.e., benefits net of the value of any employee contributions, except that before-tax salary reduction amounts are generally considered to be employercontributions.)

Plan means each option (e.g., high deductible vs. low deductible) within each plan version (e.g., indemnity plan, HMO, PPO). "Plans" within 5% difference in value can be treated as one plan. Family coverage may by tested separately from single (employee-only) coverage. Thus, for example, a sponsor with an indemnity plan with a high and a low option and two HMOs could have eight plans to test: high option indemnity-single, low option indemnity-single, HMO #1-single, HMO #2-single, plus a family coverage version of each.

Plan Value is determined under tables to be prescribed in Treasury Department regulations.

Line of Business exception permits an employer to separately test plans offered to employees in either separate lines of business or geographically separate operating units. Any such line of business or operating unit must be operated for bona fide business reasons, have at least 50 employees and meet requirements established by Treasury.

THE TESTS

All plans must meet the Qualification Requirements. All life insurance and health insurance plans must meet the Nondiscrimanatory Provisions Test and either (1) the three Eligibility & Coverage Tests or (2) the Alernative 80% Test.

QUALIFICATION REQUIREMENTS: Each plan must be (a) in writing, (b) legally enforceable by participants, (c) communicated to employees, (c) provided for the exclusive benefit of employees and their dependents, and (e) intended to be permanent. Failure to meet these requirements will result in any benefits paid from the plan being included in the taxable income of the recipient.

NONDISCRIMINATORY PROVISIONS: The plan cannot contain any provision which discriminates in favor of the HCEs.

ELIGIBILITY AND COVERAGE TESTS: Plans must meet all of the following tests:

50% ELIGIBILITY TEST: At least 50% of those eligible for a plan must be NHCEs OR the percentage of NHCEs eligible must be equal or greater than the percentage of HCEs who are eligible. Each plan is tested separately.

90%/50% TEST: 90% of all NHCEs must be eligible for a plan with a benefit equal to at least 50% of the most valuable benefit for which any HCE is eligible. All plans of the same type are aggregated.

BENEFITS TEST: The average benefit actually received by NHCEs must be at least 75% of the average benefit received by HCEs. All plans of the same type (e.g., health plans) are aggregated. Tests are based on actual coverage, not on eligibility for coverage.

ALTERNATIVE 80% TEST: The plan covers 80% of all NHCEs. Test is based on coverage, not eligibility. The definition of "plan" makes this test useful only in limited situations.

Plans which fail to meet these requirements result in the "discriminatory excess benefit" being included in the taxable income of affected HCEs. To determine the taxable excess for the HCEs, reduce each HCE's employer-provided benefit (starting with the HCE with the highest benefits) until the plan passes either the ALTERNATIVE 80% TEST or the ELIGIBILITY AND BENEFITS TESTS. The result is the highest permitted benefit. The discriminatory excess is the amount by which an HCE's benefit exceeds that permitted benefit.

The above represents a brief explanation of basic provisions of section 89. Employers should contact their benefits advisors and/or legal counsel to determine the details and effects of section 89 on their particular benefit programs.

October 1988

SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS
2033 M Street, NW • Suite 605 • Washington, D.C. 20036 • (202) 223-6413

Testimony to the U.S. House of Representatives
Committee on Small Business
Impact of Internal Revenue Code Section 89 on Small Business
January 25, 1989
Richard A. Raup, President
Business Administrators and Consultants, Inc.
and
Anne C. Lennan, Director of Research
Society of Professional Benefit Administrators

Society of Professional Benefit Administrators
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The Society of Professional Benefit Administrators (SPBA), founded in 1975, is the national association of independent third party contract benefit administration firms. It is estimated that one third (⅓) of all U.S. workers are covered by employee benefit plans administered by such firms.

SPBA members operate much like independent CPA or law firms... providing continuing professional out-of-house claims and benefit plan administration for client employers and benefit plans. Most of the plans employ at least some degree of self-funding. Client plans include those sponsored by corporations of all sizes, associations, and union/management jointly-administered Taft Hartley multi-employer plans.

SPBA membership has grown almost 700% in the past 6 years... with a current roster of almost 400 member firms. Similarly, SPBA members have seen the market for their services also expand rapidly...in large part because of the leading role of SPBA members have played in successful health cost containment efforts and cost-efficient administration techniques for pension and health benefit plans.

Mr. Chairman, my name is Richard Raup. I am President of Business Administrators and Consultants, Inc., a Third Party Administration firm that specializes in small employer health insurance plans. I am speaking today on behalf of the Society of Professional Benefit Administrators of which I am chairman. Anne Lennan, Director of Research for the Society of Professional Benefit Administrators is accompanying me and will assist in any questions that you may have.

We thank you for the opportunity to appear today, and we applaud your initiative in studying the unique problems Internal Revenue Code Section 89 presents for small businesses. Through this hearing and others, it will be possible to implement constructive changes to Section 89 before too much damage results.

Since we understand that other witnesses will discuss the technical complexity of Section 89, our testimony will provide an explanation of the small employer mind-set and suggestions for simplifying the statute, rather than an in-depth analysis of the non-discrimination tests.

Small Business Predicament

The typical small business employer first hears about Section 89 through an article in a local newspaper warning employers about a new law that could impose enormous tax penalties on employers and employees if ignored. This article usually mentions the most daunting of all Section 89 penalties which result from a failure in the "qualification requirements": the claims or reimbursements received under the plan become taxable to the employee and the employer is taxed on the highest individual tax rate multiplied by the total claims or reimbursements received. Thus, if an employee incurs $20,000 in medical claims, this amount must be included as taxable income on the W-2 Forms. With this news, the small employer is driven to seek additional information on the law from knowledgeable sources. After numerous discussions with the so-called experts in the field and hours spent reading voluminous material on the subject, the small employer is completely bewildered. The so-called experts, through no fault of their own, simply can not answer some of the fundamental questions that Section 89 raises. There are five qualification requirements under Section 89 for which there is virtually no guidance in the legislative history on how to comply. The questions that plague the small employer are: What constitutes a written plan?, What constitutes "legally enforceable rights" under the plan?, What constitutes "reasonable notification of benefits"?, How can a plan satisfy the "exclusive benefit rule"?, and What length of time is necessary for a plan to satisfy the "indefinite duration rule"? In addition to these questions, the intricate quantitative non-discrimination tests with multiple aggregation rules lead the small employer to a state of intense frustration.

At this point, the small employer begins to ask why Section 89 was passed and what was its purpose. The primary reason for Section 89, passed as a part of the Tax Reform Act of 1986 that was intended to provide major simplifications to the tax code, is revenue. While the creators of Section 89 from the Joint Committee on Taxation argue that statistics demonstrate the need for non-discrimination tests of this type, these individuals will readily admit that the proposal was revenue-driven. These statistics are primarily drawn from large corporations that offer a wide array of benefits to employees of differing compensation levels. However, the small employer who has only a few highly compensated employees usually provides only one plan with the same benefits for all. Generally, small employer plans are not discriminatory and thus will not provide much if any revenue to the federal government. Instead, the small employer will be forced to spend large sums on proving to the IRS that the plans are non-discriminatory. This fact was overlooked by the creators of Section 89. It also appears that there was no consideration given to the negative effects the proposal would have on the expansion of health insurance coverage to uninsured employees, nor was any thought given to the potential effects on covered employees. As we have witnessed for some time now, tax policy has been permitted to override health insurance policy. If this trend continues with increasing numbers of employee benefit revenue-raising solutions to the deficit, the very foundation for health insurance coverage in this country, which is rooted in the tax exclusion, will further erode.

While Congress' need for revenue is understandable, the small employer wonders why Congress chose to penalize those employers who are trying to the best of their ability to provide employees with health insurance. While Section 89 imposes a labyrinth of requirements on employers who have already established plans, the employer who lacks a health plan is uneffected. When first learning about Section 89, many small employers believe that the only solution is to eliminate the health plan. And yet the small employer who has a close working relationship with employees and is concerned about their well-being does not take the option of eliminating plans lightly and will only exercise that option when it becomes apparent that there is no other way to solve the problem. For some small employers, the problems presented by Section 89 are insurmountable. The small employer has a limited amount of funds and in many cases can not afford the high priced attorneys, benefits consultants, or other experts who can perform the tests. Even if a small employer could afford to utilize professional Section 89 services, the small employer still must live with the constant fear that the professionals will overlook some aspect of the law (not difficult to do given the complexity) and thereby cause a plan to operate in violation of Section 89 with tax consequences that could bankrupt a business. As mentioned earlier, if a plan fails one of the five "qualification requirements," the employees must include the claims or reimbursements in taxable income. Undoubtedly, the small employer could anticipate a law suit from an employee who faced this type of tax penalty.

In the past, Congress has responded to the small employer dilemma by making the situation worse with mandates, such a national health insurance and COBRA continuation coverage. When Congress hears that employers are considering eliminating their plans, Congress becomes angry, immediately lashing out with punitive measures rather than analyzing the reasons underlying employers actions and creating solutions that will assist the small employer in his goal of providing health coverage. Will Congress ever learn to listen to the small employer's call for help?

Small employers are trapped in a no-win situation. The small employer wants to comply with Section 89 and yet is overwhelmed by the data collection burden and by the costs of Section 89 software and advice. Lacking the time and money to second guess the IRS on regulations which were required to be issued on November 15, 1988 under The "Technical Corrections and Miscellaneous Revenue Act of 1988" (P.L. 100-647), many small employers are forced to forego non-discrimination testing by including the total value of the plan in the incomes of the highly compensated employees and increasing salaries to offset the additional tax. This approach to Section 89 was undeniably intended by its revenue-driven creators in the Treasury Department and the Joint Committee on Taxation. However, this approach hinders the ability of small employers to extend health insurance to more workers as available funds must be used for paying tax penalties. It is less expensive for the small employer to offset tax penalties than it is to test plans by purchasing software and professional advice. Thus, the people who benefit from Section 89 are not the non-highly compensated employees, but rather the benefit consultants.

Mr. Chairman, you are probably wondering why a representative of the Third Party Administration industry would be criticizing a law that would result in increased administrative fees for the industry. The reason is because our primary concern rests with the strength and continued growth of employee benefit plans. While Section 89 may promise additional income at the outset, the eventual consequence of the statute will be stagnating plans.

In the interest of avoiding this consequence, listed below are suggestions on ways to ease the compliance burdens of Section 89 and thereby encourage small employers to broaden coverage.

Suggestions for Improvement

Eliminate Testing for Non-Discriminatory Plans - Section 89 penalizes the employer who pays a percentage of health insurance coverage for employees and allows the employer who contributes nothing to the cost of coverage to escape. The reason for this is because Section 89 applies to the employer-provided benefit and in an employee-pay-all plan there is no employer-provided benefit. Section 89 has clearly missed the target. The way to amend this error is to create a safe-harbor whereby an employer who offers one plan that is available to everyone and pays a set percentage of the cost would not need to go through the complicated process of demonstrating to the IRS that the plan was non-discriminatory. The explanation of the plan structure in a written document would be proof enough that the plan was non-discriminatory. With this change, most small employers could avoid the expensive costs of testing and would be able to spend more money on providing benefits.

Qualification Rules

Don't Penalize the Workers - As mentioned earlier in this testimony, the employees must pay tax on the claims or reimbursements received in the event that the employer fails to satisfy one of the qualification requirements. It is unreasonable to tax employees for an error that they had absolutely no control over. Place the blame where the blame is due, on the employer.

Remove Fines for a Good-Faith Effort - The "Technical Corrections and Miscellaneous Revenue Act of 1988" contains a good-faith compliance provision that only applies for issues that have not been addressed in regulations . Since Section 89 is especially confusing and will remain so even after regulations are issued, an employer who makes a good faith effort to comply should not be penalized. For those employers who have clearly made no effort to comply with the law, penalties should apply but with caps so that the employer will not be forced into bankruptcy.

The Burden of Written Plans Should Lie with Insurance Companies - If an employer formerly adopts a fully-insured plan from an insurance company and communicates that plan to employees, the employer should not have to be concerned with the written plan requirements. Since the insurance company has created the policy and is thus the only reliable source for determining what the policy covers, the employer should not be asked to interpret the policy for purposes of satisfying the written plan requirements. If the employer is required to perform this task, unfortunate results will follow. For example, an employee incurs a claim thinking that the employer's written plan accurately reflects the insurance company policy. However, when the employee submits the claim for reimbursement the insurance company denies payment, arguing that the claim is not covered under the policy. The employee feels deceived and becomes outraged. To avoid this, the creator of the policy must also fulfill the written plan requirements and give this document to the employer.

Disregard Collectively Bargained Employees - Collectively bargained employees must be included for testing purposes. These employees may only be excluded in the most unlikely case where the union representatives have bargained not to receive benefits of the type being tested. For example, if health coverage was being tested and the union representatives had bargained not to receive health coverage, then the union employees could be excluded -- a situation that never occurs.

One of the first complaints small employers levy against the collectively bargained provision concerns the intentionally confusing statutory language. Section 89 clearly lists collectively bargained employees as one of the groups that may be excluded from testing. However, another obscure provision in the statute disallows the exclusion. The statute was written in this way to disguise the meaningless exclusion so that employers would remain quiet until after the bill was passed when they would eventually discover the truth. (Many employers, lacking the technical expertise, still have not ascertained the truth and operate under the misconception that their union plans are safe). Once again, this tactic was used not in the interest of sound health policy, but rather for revenue gain.

Since collectively bargained plans are the products of negotiations between employee representatives and employers, it is unreasonable for Congress to violate these agreements by subjecting them to testing. If a collectively bargained plan was found to be discriminatory when tested with other employer plans, the employer would have only one course of action in order to avoid penalty taxes: re-negotiate the collectively bargained agreements. However, as new highly compensated employees are hired and move on an employer's plan, the passing non-discrimination percentages may be thrown off, requiring yet another re-negotiation of benefits.

Gathering data for testing collectively bargained plans is particularly troublesome for the small employer. Small employers in the past have never bothered to maintain information on the type of benefits received and compensation levels of their collectively bargained employees . These employers simply agreed to contribute a certain amount to the collectively bargained plan on behalf of these workers. Mailing the contribution to the plan administrators office has been the extent of the employer's involvement with the union plan. However, Section 89 will dramatically alter this involvement as employers will need detailed data on all the benefits (including information on deductibles, options, and waiting periods). In addition, the small employer will now be responsible for tracking income earned by the union workers who move from one job to another throughout the year.

Will the small employer have the time and resources to perform all these gyrations? No. Since the collectively bargained employees have formally agreed under a binding contract to their benefit levels, it is absurd to force the small employer to test these plans. *Collectively bargained plans should be exempted from Section 89.*

Ease Part-Time Employee Rules - One of the most difficult aspects of Section 89 concerns the treatment of part-time employees. Section 89 requires that all employees working at least 17 1/2 hours per week must be included when applying the non-discrimination tests. Most small employers can not afford to provide health coverage for employees working less than full-time (usually defined as a 30 to 40 hour work week). Congress recognized that part-time employees would pose significant problems in passing the tests and thus created rules permitting employers to provide lower levels of coverage. Under these rules, a part-time employee who works less than 22 1/2 hours per week may be considered to receive coverage at twice the actual value and part-time employees who work between 22 1/2 and 30 hours per week may be considered to receive coverage at 1 1/3 times the actual value. In addition to this rule, Congress granted employers with under 10 employees a phase-in period for the definition of part-time employees: for 1989, employees working under 35 hours per week may be excluded; for 1990, employees working under 25 hours per week may be excluded; and then for 1991 and on, the 17 17 1/2 hour rule applies. Though well-intentioned, these allowances fall short of providing meaningful relief. *The phase-in should be expanded to cover employers with 100 or less employees as these employers are also small and in need of the rule. The phase-in rule for 1989 should be extended for at least 5 years until a study can be conducted on the impact of the 17 1/2 hour rule on small businesses.*

How will a change in the part-time employee rule broaden coverage? As the part-time employee rule presently stands, small employers will avoid the rule altogether by taxing the benefits of the highly compensated employees and will not even attempt to pass the non-discrimination tests. In so doing, full-time non-highly compensated employees will not have to be taken into account. On the other hand, if the part-time employee rule was relaxed as described above, more small employers would choose to tests their plans and cover full-time nonhighly compensated employees in order to pass. Most small employers simply are not able to cover part-time and full-time non-highly compensated employees. With this change, small businesses would not be hit with the impossible task of having to cover both groups but would be free to cover one group.

Remove Open-Season Rule - Under the open-season rule, employees may not be disregarded from testing (due to coverage received elsewhere) unless they have the right to elect health coverage from the employer in the event that other coverage ceases without regard to whether it is open-season (enrollment time). The right to elect health coverage must be on the same terms as if the employees were electing coverage at a subsequent enrollment period. Congress, through this provision, is clearly expressing a dissatisfaction with the evidence of insurability requirement that insurance companies have found useful in maintaining solvent plans. While Congress has not eliminated the use of this mechanism, Congress has withdrawn the flexibility that insurers need to have the mechanism operate effectively. The open-season rule requires plans to contain either an evidence of insurability demonstration during the enrollment and non-enrollment periods or not at all. The insurer no longer has the option to place an evidence of insurability demonstration in only the enrollment periods. In so doing, Congress has withdrawn the freedom that has allowed insurers to develop strategies that are successful for each different employer group. With this rule, we will witness reductions in the availability of coverage and a rise in the number of insolvent plans. *Congress should eliminate the open-season rule and permit the professional expertise of insurers to perform freely, thereby safeguarding employee benefit plans.*

Disregard State Mandated Benefits - Under present law, only ancillary (i.e., noncore) state mandated benefits may be disregarded when applying the non-discrimination tests. For the small employer with employees living in different states that mandate various core benefits, passing the tests can be an impossible task. In this case, the employer is penalized for having no control over the state mandates. *Small employers should be permitted to disregard core state mandates.*

Thank you, Mr. Chairman, for giving careful consideration to our testimony. Your willingness to examine the impact of Section 89 is greatly respected and will certainly bring you into high regard with small employers throughout the country. We look forward to further discussions with you concerning this important matter.

National Society of Public Accountants

STATEMENT ON
THE IMPACT OF SECTION 89
OF THE INTERNAL REVENUE CODE ON SMALL EMPLOYERS

SUBMITTED BY THE
NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

FOR THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 25, 1989

1010 N. Fairfax Street, Alexandria, Virginia 22314 (703) 549-6400

Testimony

Introduction

My name is Don Hull and I am pleased to be representing the National Society of Public Accountants (NSPA). I am an independent accountant from Westminster, Maryland and enrolled to practice before the Internal Revenue Service. The National Society commends Chairman John LaFalce and the House Small Business Committee for holding this most important hearing on the topic of Section 89 of the Internal Revenue Code.

The National Society represents over 23,000 independent practicing accountants and tax professionals, including 8,000 enrolled agents. Our members provide accounting, auditing, management consulting, financial planning, tax preparation, and tax planning services to over 4 million individuals and small business clients.

Independent accountants are finding it most difficult in providing timely competent professional services to their small business clients, especially under circumstances of constant changes in the tax law and regulations. Section 89 must be viewed in this same light. In particular, testing and compliance for Section 89 is likely to fall directly on the independent accountant and thus, create an additional burden on the small practitioner. This additional burden may result in increased fees for independent accountants. Unfortunately, NSPA does not view this particular type of increased workload for tax practitioners as beneficial to the business community or to the American workforce.

The stated purpose of Section 89 is not consistent with what is happening in the marketplace. The apparent purpose of this code section is to ensure (through various qualification and non-discrimination rules) that lower paid employees receive the same relative level of employee benefits as higher paid workers. Section 89 would affect such employee benefits (among others) as accidental or health plans, group term life insurance, qualified tuition reduction program, and cafeteria plans.

The real purposes of Section 89 have to be seen as something other than the stated purpose. Industry and labor view this code section as really being a revenue raiser and a means of taxing the fringe benefits of the workforce. Some revenue estimates suggest that the Federal government may gain as much as $500 million in additional revenues over the next three years as a result of Section 89.

For the accounting profession, NSPA believes that Section 89 should be viewed as one more complex measure added to the tax code. The National Society considers Section 89 as a disincentive to starting a small business. It only adds to the frustration level of persons who would ordinarily want to become an entreprenuer in our country.

Section 89 is not only a tax on fringe benefits, but it is also a measure which significantly increases the paperwork and recordkeeping burdens of the business community.

Compliance Rules of Section 89

As we stated earlier, Section 89 of the Internal Revenue Code has added significant administrative and compliance burdens for small business. Under Section 89, employee benefit plans must generally meet difficult qualification standards and non-discrimination rules.

Employee benefit plans subject to the qualification rules of this code provision must meet five general requirements. The first three requirements state that the plan must be in writing, the employees' rights under the plan be legally enforceable, and employees be provided reasonable notification of benefits available under the plan. Further, the last two requirements state that the plan be maintained for the exclusive benefit of employees, and the plan be established with the intention of being maintained for an indefinite period of time.

If the plan does not satisfy the qualification rules of Section 89, then an individual receiving benefits under the plan must include the entire value of the benefits received as gross income. For employers, they face a very severe penalty if they fail to report the value of the benefit on the W-2 form of the employee.

With respect to the non-discrimination rules under Section 89, these rules must be applied to all accident or health plans and group term life insurance plans. The non-discrimination rules are optional in application to various other employee benefit plans.

These rules require that the plan not discriminate against lower paid employees both with respect to eligibility and level of benefits received. Should a plan be found to be discriminatory, the highly compensated employee (receiving benefits under the plan) would be required to report additional income based on the value of the excess of benefits received during the plan year. This income would then be reported on the W-2 form of the highly compensated worker. If the employer fails in reporting the income on the W-2 form, the firm is subject to a significant penalty.

Although the technical details of the rules are beyond the scope of this testimony, NSPA is concerned about the tremendous complexity of the 80% coverage test, and the mechanical rules of the eligibility and benefit tests involved with the non-discrimination rules. These rules are likely to result in an employer being forced to cope with burdensome data collection and benefit valuation procedures, which could also result in a significant financial cost in terms of compliance to the employer as well.

Despite these burdensome compliance procedures, independent accountants and their small business clients are frustrated with the fact that the IRS has not released any regulations on Section 89 as of yet.

Impact of Section 89 on the Economy

One of the major political issues of recent years has been the quest by Congress to extend health coverage (and other employee benefits) to a larger and larger segment of the American workforce. The National Society contends that Section 89 is counterproductive to this political objective.

Many accountants are recommending to small business clients that it may be advisable (and thus, less expensive) to drop coverage in their employee benefit plans, rather than meet the costs associated with compliance under Section 89.

Compliance with this code section could lead to a significant lessening in an employer's flexibility in making prudent management decisions. An employer might find it prudent to hire more and more part-time workers (at reduced hours) in order to legally avoid violating certain technical rules of Section 89. Under such circumstances, these newly hired part-time workers are no closer to receiving health benefits than they were before. On the contrary, management and workers have suffered. As a result, a worker might be working less hours with no health coverage at all.

The cost to an employer of providing health insurance to a part-time worker can be substantial. For example, if a firm hires an individual to work 20 hours a week at a minimum wage of $4.00 per hour (i.e., wages of $320 per month), the cost associated with providing minimum health insurance coverage to that person alone could easily exceed $60 per month. This particular example illustrates why an employer may desire to reduce the worker's hours in order to avoid the compliance burdens of Section 89.

One commentator has stated that the Section 89 rules can be "gotten around" by merely providing health coverage and other employee benefits on an after tax basis. A statement of that type ignores the realities of the marketplace. In actuality, the employer is likely to encounter a significant increase in the cost of the compensation packages that he offers his workforce. Thus, in order to retain key employees under circumstances where the employee has imputed income based on the receipt of an employee benefit, the firm may have to offset this tax situation with an increase in that key employee's salary. This may be necessary in order to retain the individual as an employee.

Conclusions

Section 89 does little to accomplish the objective of expanded health and life insurance coverage for the American workforce. Instead, this code provision serves as a disincentive to expanded coverage. The compliance rules of Section 89 are likely to encourage employers to discontinue various employee benefit plans for their staff.

Ironically, for all of the purported social reasons for enactment of Section 89, equality of health coverage continues to be overlooked for many small business owners. Self-employed persons (i.e., certain sole proprietors, partners, and S corporation owners) are only allowed to deduct up to 25% of amounts paid for health insurance for themselves and their families.

Your committee has taken significant steps to rectify this situation. The National Society would like to commend Chairman LaFalce and the other members of the House Small Business Committee, for their continued support of full deductibility of health coverage for self-employed persons.

The National Society believes that Section 89 should be repealed because of the complexity and recordkeeping burdens placed on smaller employers by the measure. In the absence of repeal, Section 89 should not be effective until a minimum of 12 months after regulations are publicly released by the Internal Revenue Service. Further, such regulations should include a simplified data collection and benefit valuation procedure for employers who don't offer multiple health and life insurance plans to their workers.

It is NSPA's pleasure that the House Small Business Committee has invited the Society to testify at this most important hearing. The National Society stands ready to help the committee in its efforts to mitigate the harsh impact of Section 89 on small employers and the American workforce.

STATEMENT OF CHAIRMAN JOHN J. LaFALCE
COMMITTEE ON SMALL BUSINESS
HEARING ON
SECTION 89 EMPLOYEE BENEFIT RULES
March 21, 1989

The Committee has scheduled today's hearing to continue its examination into the problems associated with Section 89 of the Tax Code. This is the Committee's third hearing on the employee benefit rules that took effect January 1st. Our previous hearings on January 24th and 25th explored the impact of the new nondiscrimination rules on small businesses and their effect on the expansion of health insurance coverage.

We learned at those hearings, based on testimony from business owners and employee benefit practitioners, that Section 89 is likely to impede access to health benefits among the nation's uninsured workers. Small businesses, in particular, will be discouraged from offering health insurance and may be prompted to reduce or even eliminate the benefits they now provide.

Section 89 requires all employers to collect detailed data on their employees, assign values to each of their benefit plans, and conduct a series of numerical tests to determine if their health and life insurance plans are distributed fairly between their highly-compensated employees and average workers.

We will hear more today about the extreme complexity of the law and the recently issued regulations, and the costly administrative burden it imposes on employers. Specifically, we will focus on the impact of the law on the public sector, on the educational community, and on nonprofit institutions. Witnesses representing each of those sectors will discuss the particular problems they face in attempting to comply with Section 89.

We are also fortunate to have with us two former Treasury Department officials who will address some of the tax policy issues raised by Section 89 and the economic effects of the law.

The bill I introduced two months ago to repeal Section 89 now has 254 co-sponsors. I believe that the law is so inherently defective, so contrary to sound tax policy, that it ought to be repealed. It should be repealed and rewritten to establish a far more reasonable, simplified approach to achieve the policy goal of assuring fair distribution of employee benefits. I look forward to our witnesses' suggestions in that regard.

Our witnesses are:

Donald C. Lubick, former Assistant Secretary of the Treasury for Tax Policy in the Carter Administration, and General Partner with Hodgson, Russ, Andrews, Woods and Goodyear

Dr. Norman B. Ture, President of the Institute for Research on the Economics of Taxation, and former Under Secretary of the Treasury in the Reagan Administration

Mayor Karen B. Johnson of Schenectady, New York, on behalf of the United States Conference of Mayors

Terry Wood, President of the City Council of Jacksonville-Duval County, Florida, on behalf of the National Association of Counties

Dr. Frederick R. Ford, Executive Vice President and Treasurer of Purdue University, on behalf of the American Council on Education and the National Association of College and University Business Officers

Howard Rohan, Vice President for Human Resources, Samaritan Health Services in Phoenix, Arizona

Gary B. Kushner, Employee Benefits Consultant, representing the American Society for Personnel Administration

Ron Danilson, Associate Director - Group Underwriting, of The Principal Financial Group in Des Moines, Iowa

STATEMENT OF THE
HONORABLE JOSEPH M. MCDADE
VICE CHAIRMAN
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
CONCERNING SECTION 89 OF THE
INTERNAL REVENUE CODE
MARCH 21, 1989

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As the Vice Chairman of the Small Business Committee, I have heard the pleas of help from the small business community in regard to Section 89 of the Internal Revenue Code.

The men and women who operate the small businesses of this country are not insensitive to the needs of their workers. They provide the best benefits and coverage to as many workers as they can within the constraints of their budgets. For the federal government to step in and tell small business owners, whose lives are at stake in the success or failure of their business, that it can better run their firms, that it can better decide how to administer their health coverage programs, that small businesses discriminate against their employees, is an unwarranted intrusion.

I believe that the Members of this body know the importance of small businesses to the economic might of this nation. Of all the businesses in America, nearly 99% of them are small. Over 60% of the net new jobs in this country are created by small firms. Of all the workers in this country, 55% are employed in small businesses. Small businesses generate nearly 40% of the Gross National Product of this country. In the next 25 years the United States must create 43 million new jobs, and small business will create 75% of these new opportunities. These numbers are impressive. These are the facts which back up the bold statement that America's economy is strong and growing. But if you take the time to look behind these impressive figures, to see the people and hardships that lie behind a small business, you get a clearer picture of the flaws in Section 89. When I look at the big numbers I also see Masonry Contracting in Vandling, Pennsylvania which employs 3 workers. I see Bliss' Hardware in Wellsboro, Pennsylvania employing 5 workers. And I see the Olde Kingsley Inn located in Renovo, Pennsylvania employing 35. These small firms are just three examples of small businesses fighting to fulfill the American dream. To come along out of the clear blue and hit these struggling entrepreneurs with an awesome amount of paperwork and regulations that are barely decipherable by experts runs contrary to the best interest of the American people.

I have stated from the beginning of this fight for repeal that the goals of Section 89 are admirable and I strongly support them. But Section 89 in actuality does exactly the opposite of what it is intended to do. It could cause thousands of the small firms like those I described to cease providing their employees any benefits at all.

SILVIO O. CONTE
First District, Massachusetts

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Opening Remarks of
the Honorable Silvio O. Conte
Hearing on Section 89 - Employee Benefit Rules
March 21, 1989

Mr. Chairman, thank you for convening this third hearing on the problems of Internal Revenue Code Section 89. I am pleased to state that I am the first original cosponsor of H.R. 634, a bill you introduced, which will repeal this burdensome legislation.

While we all support the goals of Section 89 it is manifestly apparent that its implementation would exacerbate rather than ameliorate the health benefits coverage problem in the United States. When confronted with Section 89 employers have basically three choices- 1) comply and bear full costs for data gathering and testing, 2) ignore and face possible sanctions, or 3) drop benefit programs all together. If employers pursue option number three, and indications are that they will, then the 37 million uninsured in America will rise greatly - just the opposite effect of what the creators of this legislation intended.

Small businesses all over the United States have written me in support of H.R. 634. There has also been a plethora of articles in the media about the burdensome impact of Section 89, and just this morning Mr. Chairman, you held a press conference to tell America that 252 of our colleagues have signed on to H.R. 634. The message is strong and clear. Small business owners all across America want relief from Section 89. As members of the Small Business Committee we must lead the Congressional response and repeal it.

But Mr. Chairman, as we all know more than just small business is impacted by this regulation - all employers must comply. I look forward to the testimony of our distinguished witnesses today regarding the impact of Section 89 on non-profits, the public sector and the educational community and commend the Chairman and America's small businesses, indeed all American employers, for their unified and vigorous response to Section 89. Thank you.

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TESTIMONY OF DONALD C. LUBICK SUBMITTED TO COMMITTEE ON SMALL BUSINESS HEARING ON IMPACT OF SECTION 89 OF THE TAX CODE

March 21, 1989

Mr. Chairman and Members of the Committee:

I am pleased to present this statement on the vexing issue presented by Section 89 of the Internal Revenue Code added by the Tax Reform Act of 1986.

Section 89 of the Internal Revenue Code of 1986 purports to tax as income the value of discriminatory accident and health and group term life insurance coverage provided by an employer for a highly compensated employee. Few enactments in the history of the income tax have created such an outpouring of outrage and frustration over a question not of substantive policy, but of compliance hardship.

The reason for the depth of this reaction is Section 89's almost universal applicability with year in and year out compliance burdens upon employers for their employed workers, thus affecting the fringe benefit most important to American workers everywhere -- their health insurance protection. It is an area where the general perception was that the tax law was working fairly well.

Before the 1986 Act, gross income excluded employer financed health insurance coverage without limitation on account of the amount provided or the class of employees covered. The receipt of benefit reimbursements on account of such insurance coverage is also excluded from income from the first dollar. Moreover, non-insured expense reimbursements from employer established salary reduction cafeteria plans were also excluded from taxation from the first dollar. Thus an employee with employer provided coverage does not face the disallowance problem that an individual without employer furnished protection faces on account of the floor (now 7 1/2% of adjusted gross income) to qualify for the medical expense deduction. For the covered employee both the premiums paid by the employer and the benefits reimbursed by the insurer are tax free without limit.

Some inroads had been made into the general tax exemption for non-insured employer medical reimbursement plans by limited nondiscrimination requirements added in 1978 (Section 105(h)) and the requirement in the case of a group health plan to permit temporary continuation coverage at the employee's expense if the employee terminated employment (Section 106(b). But by and large the employer financed insured health delivery system was outside the reach of the income tax.

The cost to the federal Treasury in foregone income and payroll taxes through this tax expenditure is high. It is now rapidly approaching $50 billion. Cafeteria plans were feeding the growth of this tax expenditure at an unanticipated heavy rate prior to 1986. Hence, it was not unexpected that the original tax reform proposals in 1984 aiming to move to a comprehensive income base looked to a narrowing of the almost unlimited exclusion. So Treasury I sought to limit the exclusion from taxation of employer financed health insurance coverage to an indexed $70 per month for individuals and $175 per month for coverage provided for both a worker and the worker's family. It also proposed to eliminate completely the $50,000 exclusion for employer financed group term life insurance under Section 79. In 1964 that limit had been carved out of a prior unlimited exclusion and in 1982 and 1984 had been subjected to certain non-discrimination requirements affecting "key employees" (officers and owners).

Predictably the proposal to limit the employer financed health insurance exclusion drew heavy fire from the insurance industry and employer associations. It also, however, was the target of labor unions, who viewed with dismay any diminution in the tax exemption of what is perhaps their major fringe benefit, even if few of their workers received coverage beyond the proposed limits. Visions of camels' noses and feet in doors made them anticipate an ultimate danger to what presently remained safe.

The pragmatists at the new Treasury in 1985 dropped the original proposal and floated an ill-conceived and still-born proposal to tax a minimum first dollar part of the exclusion but to retain a sky-is-the-limit overall exclusion. Also tucked in the proposal was a call for uniform non-discrimination rules for fringe benefits applicable to a prohibited group that included the highly compensated. The percentage of the prohibited group benefitting under the plan was not to exceed 125% of the percentage of non prohibited group employees actually benefitting.

The tax writing staffs of the Congress and Treasury took that proposal to require non-discrimination and engrafted a series of sections that may have theoretically sound bases but are unrealistic in their practical application.

The result is a statutory enactment that imposes a learning and compliance burden upon employers without parallel, that has health policy delivery implications not considered by experts in those areas and that has overwhelmed employers, their personnel offices, the insurance industry, accountants and attorneys advising countless small businesses, and IRS audit staff.

Chairman Rostenkowski is quoted in the BNA Daily Tax Report of March 3, 1989 (G-4) as saying "under the current provisions you don't even know where to go to get answers, and that's terrible." The IRS two and a half years after enactment, and many months after a legislative deadline, announced about 150 pages of proposed regulations on many but but no means all of the important problem areas under Section 89. The regulations propose transitional rules and tests that seem to have no legislative authority, but ones that the IRS obviously felt contained delays and concessions necessary to defer a complete breakdown.

The proposed regulations estimate that the annual burden per respondent/recordkeeper for learning about the law, testing and making elections varies from 1 to 40 hours with an average of 10 hours. That is patently absurd based upon our actual experience in briefing even professionals on the generalities of the statute. 40 hours might possibly be a minimum burden, but the average is certainly far, far higher. The IRS further estimates an annual reporting and/or recordkeeping burden of 9,000,000 hours. Again that is commonly viewed as no closer than 25% of the likely reality, but even taking that estimate at an inconceivably low average cost of $30 per hour, an annual compliance cost of $270 million compares with the 1986 Act estimate of revenue to be derived from Section 89 of $72 million for fiscal

1988, $120 million for fiscal 1989, $140 million for fiscal 1990 and $154 million for fiscal 1991. The most conservative projected annual cost of compliance exceeds the enactment revenue raising estimates by more than double!

As any complex section, Section 89 contains a host of obscure technical provisions and traps that any complier is apt to miss without the benefit of far more study and sophistication than anyone can acquire in the 40 hour annual maximum allotted by the proposed regulations for learning, testing and electing. But even a general understanding of the provision requires evaluating the following:

1. Sort out the employer's highly compensated employees ("HCE's") from the non-highly compensated ("non-HCE's"). This requires compensation data for the current and preceding year. Section 414(q). Naturally there are family attribution rules (Section 414(q)(b)), decisions as to what constitutes compensation (Section 414(q)(7)), rules as to excluded employees based on service, part-time status, seasonal status, age, and maybe or maybe not collective bargaining status -- (Section 89(h)).
2. Determine, if the employer has more than one location, whether testing by separate line of business is permitted. Census and geographical data are needed. Also there are special rules to cope with for allocating headquarters personnel, since they can never be tested separately from all other locations or lines of business. This important part of Section 89 is still without regulations guidance.

3. Eligibility tests. Without going into explanation, there is a 90%-50% test based on the number of non-HCE's eligible and the benefit they have available compared to that available to HCE's, a 50% test based on eligibility in a particular plan, a general non discrimination test and an alternative eligibility test based on comparative percentages between HCE's and non-HCE's.

4. Benefit tests. There is a 75% benefit test based on average benefit coverage for HCE's and non HCE's, including in the averages each non participant as a zero.

5. There are alternative coverage tests of 80% or 90% of non-HCE's actually covered. Which percentage applies is dependent on valuation differentials among different plans of the same employer.

6. Valuation and plan determination complexities. These are among the most perplexing. First, there are obvious difficulties in assigning "values" to health benefits when health costs (which are a proxy for value) vary dramatically based on geographic areas and workforce demographics. Moreover, if values can be determined and adjusted to eliminate regional and demographic variations, each benefit option and individual vs. family coverage is treated as a separate plan. Again there are exceptions to master. The rules as to aggregation of plans to treat them as a unit to satisfy the percentage tests are most important and complex.

7. There are rules on testing dates, and much learning on who can be excluded on account of coverage under another employer's plan (e.g., a spouse's employer) and how to

identify such persons.

The proposed regulations give relief in a number of situations by adding more numerical safe harbors and tests. Each one relieves a certain number of employers, but adds to the complexity by requiring more factors to consider. One seems designed to limit the burden of the government as employer, leaving the suspicion that IRS was taking care of its own with the private sector's woes treated more cavalierly. Employer reaction to the relief given by the regulations has not been gratitude, but rather increased dismay.

After an employer solves all the problems as to its health and accident plans, the same complex rules apply to test for discrimination in its group term life insurance coverage. Such a complex mechanism is hard to justify in the context of an already limited exclusion under Section 79.

Finally, Section 89(k) applies overriding rules of includability in income of benefits received (e.g., insurance proceeds) under enumerated plans including health and accident, group term life, cafeteria plans, certain fringe benefit programs for no-additional-cost services, etc. if the plans are not in writing, communicated to employees, maintained for exclusive benefit of employees, etc. Although the requirements were at first not expected to be hard to satisfy, the regulations require a greater degree of complexity that will produce more non compliance than anticipated. Section 89(k) was added to protect employees by making sure that their employers gave them notice and enforceable rights. It is, therefore, totally bizarre that, not the errant employer, but the innocent employee, rank and file as well as HCE, is visited with the sanction for the employer's error. The proposed regulation creates non-statute based relief by deferring effective dates for action and limiting the income subject to penalty in inverse ratio to an employee's compensation (not necessarily in relation to the employee's innocence).

A Suggested Cure

It is almost beyond a reasonable doubt that Section 89 as it stands is a gross error. The case for total and unconditional repeal has not been made, however. The Committee Reports under H.R. 3838 (the Tax Reform Act) stated that the exclusions for fringe benefits are justified only if they fulfill important social policy objectives, such as increasing health insurance coverage among taxpayers who would not purchase it otherwise or would not be offered such benefits.

There is a way to achieve the objective with less precision than Section 89, but cost effectively. That way is to limit the exclusion for HCE's, if there is assurance that their excluded benefit is part of sufficiently broad general employee coverage so as not to be a device to benefit only a handful of highly paid employees. Full exclusion can be preserved for non-HCE's to satisfy any reasonable concern of labor and those who wish the tax exclusion to encourage greater protection for the rank and file. There is no need, however, for an unlimited subsidy for health insurance for the highly paid. Thus, no exclusion for a highly compensated employee could exceed a fixed threshold. The excluded amount for an employer financed cost could be 100%, or some higher percentage such as 110%, of the highest subsidy paid by the Federal government as an employer.

Presumably this would effectively build in indexing. Alternative thresholds for employer contributions expressed in indexed dollars, as $100 a month individual, $250 a month family, could be used. But they would apply to HCE's only.

Second, to preclude plans for HCE's only, even though limited in value, HCE's would be entitled to the basic up-to-the-threshold exclusion for employer financed contributions only if a sufficient number of non-HCE participants actually are covered on the same basis. For example, one could require that HCE's be no more than 20% of the employees actually covered. Family and individual coverage would not be treated as separate plans if offered at the election of employees. Cases of gross abuse could be protected by the general non-discrimination requirement of Section 89(d)(1)(3), as where the individual coverage is contributory and family coverage paid by the employer, if the only employees with families are HCE's. In addition, for small employers where the 20% test could not be met on actual participation because of insufficient numbers of non-HCE's, a simple test requiring eligibility for coverage for all employees over some minimum service period would protect against abuse.

Self insured reimbursement plans and cafeteria payments of uninsured benefits could, in the case of HCE's, if generally available, be aggregated with the cost of insured coverage up to the threshold. Any excess could be deducted under the medical expense deduction.

Section 89 should be dropped altogether as to group term life insurance. Instead as to HCE's the exclusion should be reduced to $25,000.

Both of these proposals are subject to the defect of a notch. If $80,000 a year income is the line across which a non-HCE becomes an HCE, the marginal rate of taxation becomes high on the benefits that become subject to taxation by receipt of an extra dollar of wages. Of course, the high thresholds are not likely to affect many persons and then at small amounts -- only the excess. But, if need be, the easiest to apply phase in provision should be introduced.

Finally, it is doubtful that Section 89(k) is really necessary, at least with the detail required by the regulations, but if it is, the sanction should be on the employer, not the sick or the dead. The sanction should be in terms of a deduction disallowance or non-deductible excise tax (to take care of tax exempt delinquents) with a suitable correction procedure.

The objective of Section 89 can be met simply and efficiently with no revenue loss by a limitation on exclusion of benefits for HCE's. The integrity of the 1986 Tax Reform Act would be enhanced, not compromised. Then questions of how to compel broader coverage of employees, what coverage should be required for part time and leased employees and other matters relating to health care delivery policy can be addressed by those with expertise in that field.

THE ECONOMIC EFFECTS OF SECTION 89

Statement by
Norman B. Ture, President
Institute for Research on the Economics of Taxation
to the
Committee on Small Business
House of Representatives
March 21, 1989

Mr. Chairman, members of the Committee, I am happy to have the opportunity to present to you my views about Section 89 of the Internal Revenue Code. My discussion focuses on the economic and tax policy issues raised by this provision of the tax law, rather than on the technical tax details.

Overview

The objective ostensibly sought by Section 89 is to reduce, if not eliminate, discrimination in employer-provided fringe benefits in employees' compensation packages. The concern, presumably, is that higher-paid employees are afforded more valuable fringe benefits as compensation components than are lower-paid employees and that this differentiation by compensation level is unfair, hence should not be condoned by tax provisions.

At issue in reconsidering this provision of the tax law is whether the legislation effectively pursues an appropriately conceived fairness goal and what costs Section 89 imposes in pursuit of this goal.

Does Section 89 Pursue the Right Objective?

Section 89's objective, if I have properly identified it, badly misses the mark. In essence, the provision identifies fairness as requiring all employees to have the same kind and amount of certain compensation elements, primarily health and life insurance, included in their pay packages, irrespective of the preferences of the employees and irrespective of what other pay components they must forgo as a result. In brief, this sort of "fairness" requires the sacrifice of employees' freedom of choice and imposes severe constraints on the choices available to them. Section 89 mistakes sameness for fairness, and in its implementation it will most harshly treat employees in the weakest economic situation, ostensibly those for whom it sought to provide fairer treatment.

The least reasonable assumption one could make about any employer's work force is that all of its members prefer to be compensated in the identical way. The U.S. economy is extraordinarily diverse, relying on an enormous variety and range of work skills and employing individuals of greatly differing backgrounds, family responsibilities, and economic circumstances. In this economy, efficient compensation policies call for diversification of the pay package to the greatest feasible extent in order best to conform each individual's pay package as closely as possible to his or her preferences and perceived needs.

There is obvious economic pressure on the employer to offer differing pay packages to differing groups of employees. Compensation packages must be acceptable to both the employer and employee. For the employer, the cost of the pay package cannot very long exceed the employee's contribution to the value of the business's output; neither can the value of the pay package to the employee fall short of the amount he or she insists on to take and keep a specific job. If an employee deems a specific fringe benefit included in the pay package to be of little or no value, the value of the other elements of compensation must be sufficient to equal the employee's reservation price for the job. The more nearly uniform is the composition of employees' compensation packages, the greater is the number of employees who are likely to be dissatisfied with a pay package of any given cost to the employer. For this reason, requiring uniformity of compensation elements is certain to exert upward pressure on compensation costs.

This fact accounts in very large part for the growing efforts by employers, at least until enactment of the Tax Reform Act of 1986, to diversify compensation arrangements by offering so-called "cafeteria plans" for fringe benefits. Allowing employees some freedom to choose among pay components, subject to given limits on the total cost to the employer, clearly enhances the efficiency of compensation. It rewards employees for their labor services in a way that best meets their demands at the lowest cost to the employer. As such, diversified compensation contributes to expansion of employment opportunities for a wider range of employees than otherwise would be the case.

There is, of course, a significant constraint on the extent to which any employer can fine tune compensation arrangements. As a result, the composition of few, if any, employees' pay packages conforms perfectly with their preferences. Nonetheless, market forces impel virtually all employers to balance the administrative costs of adjusting the pay package as closely as possible to each employee's preferences against the savings in total compensation costs that may be realized by doing so.

Section 89 appears to disregard these elementary facts about the market for labqr services in the American economy or to assume that the obvious differences in employees' circumstances and preferences have no weight in their or their employers' decisions about the best compensation program. The pressure for uniformity of the pay package exerted by Section 89 is an affront to fairness, unless one can conceive of a concept of fairness in which the preferences of the persons involved are ignored.

Section 89, in effect, asserts that employees' preferences about how they get paid is not and should not be a consideration in determining the appropriate tax treatment of fringe benefits. This kind of elitism is completely inconsistent with any meaningful concept of fairness.

Perhaps the confusion between sameness and fairness is too subtle a matter to weigh heavily in tax policy making, but surely Section 89's gross discrimination against those employees at the lowest rungs of the employment ladder should not escape policy makers' attention. One important adverse effect of Section 89 is likely to be a sharp curtailment of job opportunities for teenagers and other persons whose labor-force participation is effectively limited to part-time employment. Full-time employees with poor job skills are also likely to find themselves in a more fragile employment situation.

For purposes of determining compliance with Section 89, part-time employees working more than 17.5 hours a week must be included in the work force. In the usual case, part-time employees are not covered by group health and life insurance programs. Most often, part-time employees are not highly skilled or highly paid; for such employees, the monthly premiums for even quite skimpy health insurance plans would represent an inordinately large fraction of the employees' gross compensation. If meeting Section 89 compliance tests calls for extending health insurance to these part-time employees, their employment possibilities are likely to be severely curtailed.

For one thing, Section 89 may very well create a strong incentive for employers to alter their hiring practices to limit part-time employment to less than 17.5 hours of work per week. Part-timers working more than 17.5 hours a week may well find themselves under pressure to accept fewer hours of work per week, hence less income, possibly facing the need to find more than one part-time job. In some cases, it might be feasible to extend the insurance coverage to these employees, but only at the cost to them of significant cuts in other elements, primarily cash wages, of their pay package.

In many cases, adjustment of the pay package may not be a realistic possibility. Consider, for example, an employee working 20 hours a week at a cash wage of, say, $5.00 an hour. Suppose his employer's health insurance plan premium is as low as, say, $100 a month. If required to include this employee in the health insurance plan, the employer would be faced with a 24 percent increase in the employee's gross compensation (assuming a 50-week work year). Since nothing in these circumstances increases the employee's productivity, certainly not by anything like this amount, the employee is likely to find himself looking for another job. Alternatively, the employee could take a 24 percent cut in cash wages, from $5000 a year to $3800. There are not likely to be many circumstances in which this is a viable option for persons in this situation.

The problem may be only slightly less severe in the case of full-time but low-paid employees. Some, possibly a substantial number of such employees, may chose cash wages in lieu of health insurance coverage when this option is available to them. Facing the requirement for extending coverage to these employees, the employer is likely to find the cost of employing them increased on the order of, say, 10 percent, possibly a good deal more. Any such increase in employment cost will certainly jeopardize the continued employment of these employees. Alternatively, these employees may find themselves facing a cash wage reduction of a similar magnitude.

It must be clear that Section 89 creates a much more precarious employment situation for low-wage full-time and part-time employees. It is difficult to conceive any standard of fairness that validates this sort of discrimination.

What Does Section 89 Cost?

Section 89 not only misidentifies fairness in employee compensation, it also exerts upward pressure on the cost of employment throughout the American economy. For one thing, employers will incur significant costs in determining whether the fringe benefits included in their compensation packages satisfy the plan qualification and nondiscrimination employee eligibility and benefits tests that Section 89 prescribes. For another, the adjustments in compensation packages that many employers will have to make will raise their costs of providing satisfactory compensation arrangements. In important respects Section 89 is equivalent to the imposition of a yet another excise tax on the employment of labor services.

The Committee has heard at length, I am sure, of the nature and likely magnitude of the costs that employers are going to incur to determine whether their present fringe benefit plans conform with Section 89's requirements. Rather than reciting the nature of these tests and the kinds of costs they are likely to impose, I'll focus on the nature of the costs that employers will incur in attempting to comply with Section 89 and their broader implications for the economy as a whole.

Section 89 will increase the cost of labor services very widely throughout the economy. The administrative costs that a great many employers will incur in performing the specified tests to determine that their plans are qualified and nondiscriminatory are payroll costs, stemming uniquely from the use of labor services. The larger and more diverse the work force and, therefore, the existing compensation arrangements, the greater are these administrative costs likely to be.

In many cases, Section 89 will impel changes in compensation arrangements for one or another group of employees. One adjustment that is likely to be made in many cases is to drop the provisions in the health and life insurance plans deemed to discriminate in favor of so-called "highly-compensated" employees. The affected employees, of course, are not likely to accept the resulting reduction in compensation this would entail; the employer will have to provide other compensation the net-of-tax value of which is the same to the highly-compensated employees as the insurance coverage they lose. Alternatively, the employer and the highly-paid employees may agree to continue the discriminatory compensation, including the "excess benefits" in the employees' taxable income. In this case, too, additional compensation to these employees will be required if they are not to sustain a cut in their net-of-tax compensation.

In some cases it is to be expected that employers will find both the administrative and the compliance costs of Section 89 too heavy and will drop the offending plans. In this case, too, other compensation elements will have to be provided if the affected employees are to be as well off as before.

A far less likely adjustment of health or life insurance plans found to be discriminatory would be to enrich the plans for the nonhighly compensated employees. This adjustment, clearly, is likely to have the greatest impact in raising the employer's payroll costs. Notwithstanding, there may be circumstances in which Section 89 would force this result.

Whatever the adjustment, the effect must be to raise total costs incurred by the employer in providing a satisfactory compensation package for employees. Almost invariably, the revised pay package for employees whose pay packages must be changed to comply with Section 89 will have a greater total dollar cost to the employer, simply to keep the employees as well off as they were before the adjustment. Obviously, if the total dollar value of the new pay package were the same as the old, the new mix of compensation elements would be less desirable to the employee than the old one. If this were not the case, the employee would have sought the adjustment even in the absence of Section 89. If the total dollar cost of the new pay package to the employer is unchanged, it must be less valuable to the employee than the old one. To keep the employee as well compensated as before, therefore, the employer will have to increase the aggregate amount of the employee's compensation. Section 89 necessarily confronts every employer whose plans do not now conform with its requirements with an increase in the dollar cost of the work force.

Because nothing about the change in the components of the compensation package automatically increases employees' productivity, Section 89 must lead to both higher unit costs of labor services and lower levels of employment than otherwise would be the case. Section 89, just like an excise, imposes a wedge between the cost to the employer of using a given amount of labor services and the rewards obtained by those supplying those services. Like any excise, it reduces not only the quantity of the thing on which it is imposed but the efficiency with which it is used, as well.

Like any excise, it will disproportionately affect various groups of both employers and employees. For small businesses, the administrative costs, along with the increase in compensation costs, may well be an intolerable burden. Larger businesses may have greater capacity for dealing with Section 89 complexities, but for many of these businesses complexity increases exponentially with their size and the diversity of their organizational arrangements. Indeed, for some large businesses the data base required to undertake the Section 89 tests are likely to impose costs all out of proportion to any discrimination in compensation that may be found. Cost increases are likely to be larger for relatively labor-intensive businesses than for those that are more capital-intensive. For this reason, Section 89 is likely to impose significantly differing burdens among industries, with significantly differing effects on production costs.

Conclusions

Along with a number of other recent legislative efforts and enactments ostensibly intended to benefit one or another group in the labor force, Section 89 will prove burdensome to employees across virtually the entire work-force spectrum. Because of its adverse effects on unit labor costs, moreover, it will impair American business' competitive position in the world marketplace. It will, in sum, make virtually all employees worse off than they otherwise would be. Its burdens will be particularly severe on those employees in the weakest economic position. And all of these adverse effects stem from a misguided pursuit of a careless misidentification of "fairness."

It seems likely that tax revenue gain rather than fairness was the true objective sought by Section 89. Unless the government's revenue estimators took full account of the dynamic adjustments that will be made to Section 89 throughout the economy, actual revenue gains are likely to fall far shy of those anticipated by the Congressional tax policy makers. These adjustments will entail increases in aggregate compensation costs, virtually all of which will show up as increases in tax deductions on employers' income tax returns. What revenue is gained will have been obtained at an inordinately high price to be paid by employers and employees alike.

Section 89 is misguided tax policy and bad economic policy. Its repeal would contribute to fairer and more efficient compensation arrangements throughout the economy.

STATEMENT OF MAYOR KAREN JOHNSON
MAYOR, SCHENECTADY, NEW YORK
BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS
HONORABLE JOHN J. LaFALCE, CHAIRMAN
MARCH 21, 1989

MR. CHAIRMAN, MY NAME IS KAREN JOHNSON AND I AM THE MAYOR OF SCHENECTADY, NEW YORK. IT IS A PRIVILEGE TO TESTIFY BEFORE THIS COMMITTEE TODAY ON AN ISSUE WHICH WILL HAVE A DIRECT AND BURDENSOME IMPACT UPON THE NATION'S MUNICIPALITIES; NAMELY THE SO-CALLED SECTION 89 NONDISCRIMINATION RULES.

BEFORE I BEGIN TODAY I WOULD LIKE TO STATE FOR THE RECORD THAT WHILE I AM TESTIFYING IN MY CAPACITY AS CHAIRPERSON OF THE U.S. CONFERENCE OF MAYORS' SMALL BUSINESS SUBCOMMITTEE. THE CONFERENCE HAS NO OFFICIAL POLICY ON SECTION 89 AND THUS THE VIEWS REFLECTED HERE TODAY ARE MY OWN PERCEPTIONS AS MAYOR OF THE POTENTIAL IMPACT OF SUCH REGULATIONS ON THE CITY OF SCHENECTADY AS WELL AS ON OTHER CITIES. I WOULD ALSO LIKE TO EXPRESS MY THOUGHTS ON BEHALF OF THE GOVERNMENT FINANCE OFFICERS ASSOCIATION, WHO CONTRIBUTED TO THE WRITING OF THIS TESTIMONY.

LET ME BEGIN BY FIRST ACKNOWLEDGING YOUR INTEREST IN THIS ISSUE AND THE LEGISLATION, HR 634, WHICH YOU HAVE OFFERED WHICH WOULD REPEAL SECTION 89. YOUR KEEN AWARENESS OF THE POTENTIAL PROBLEMS SUCH COMPLEX REGULATIONS GOVERNING EMPLOYEE BENEFIT PLANS WILL HAVE WITH RESPECT TO STATE AND LOCAL GOVERNMENTS IS DEEPLY APPRECIATED.

AS THE OVERSEER OF THE REGULATORY FLEXIBILITY ACT OF 1980, THE SBA IS CHARGED WITH ANALYZING FEDERAL REGULATIONS TO DETERMINE THEIR IMPACTS UPON SMALL GOVERNMENTAL JURISDICTIONS. UNDER THE ACT, AGENCIES MUST BALANCE THE BURDENS IMPOSED BY REGULATIONS AGAINST THEIR BENEFITS, AND PROPOSE ALTERNATIVES TO REGULATIONS WHICH CREATE ECONOMIC DISPARITIES BETWEEN DIFFERENT-SIZED ENTITIES. WE BELIEVE THAT THE BURDENS OF THIS LAW FAR OUTWEIGH THE BENEFITS IN THE PUBLIC SECTOR.

FOR EXAMPLE, THERE ARE THOUSANDS OF SMALL GOVERNMENTS ALL OVER THIS COUNTRY THAT ARE RUN BY PART-TIME MAYORS AND COUNCILS WHERE NO EMPLOYEE MEETS THE HIGHLY COMPENSATED SALARY LEVELS. YET, BECAUSE THE REGULATIONS RIGUEUR THAT EVEN IF THERE ARE NO HIGHLY COMPENSATED EMPLOYEES, THAT EVERY ENTITY HAS AT LEAST ONE OFFICER AND THEREFORE SUBJECT TO SECTION 89. SPENDING FUNDS ON MANDATE COMPLIANCE COSTS COULD MEAN ONE LESS POLICE OFFICER, TEACHER OR FIREFIGHTER IN THESE SMALL COMMUNITIES.

AS YOU WELL KNOW, THESE CUMBERSOME AND COSTLY REGULATIONS COME AT A TIME WHEN LOCAL GOVERNMENTS AROUND THE COUNTRY ARE REELING FROM THE VARIOUS FORMS OF FEDERAL DISINVESTMENT IN AMERICA'S CITIES THAT HAS BEEN OCCURRING THROUGHOUT THE DECADE OF THE EIGHTIES. THIS DISINVESTMENT HAS TAKEN THE FORM OF BOTH SUBSTANTIAL CUTBACKS IN FEDERAL FUNDING FOR CITIES AND RESTRICTIONS PLACED ON TAX-EXEMPT MUNICIPAL BONDS. WE AT THE LOCAL GOVERNMENT LEVEL HAVE BEEN FORCED TO COPE WITH BOTH SHRINKING RESOURCES AND A SHRINKING TAX BASE WHILE THE PROBLEMS OF THE CITIES CONTINUE TO WORSEN. THESE COSTLY REGULATIONS COULD NOT HAVE COME AT A WORSE TIME FOR THE NATION'S CITIES AS WE TRY TO DEAL WITH ILLITERACY, RAMPANT DRUG ABUSE, A NATIONAL HOUSING CRISIS, AND A CRUMBLING INFRASTRUCTURE JUST TO NAME A FEW OF THE PROBLEMS PLAGUING THE CITIES TODAY.

I UNDERSTAND THAT THERE IS A CRUCIAL FISCAL NEED FOR REVENUE AT THE FEDERAL LEVEL TODAY AND SECTION 89 COULD RAISE AS MUCH AS $128 MILLION IN THIS FISCAL YEAR ALONE FOR THE FEDERAL GOVERNMENT. BUT FROM A COST-BENEFIT PERSPECTIVE THE COST OF IMPLEMENTING THE REGULATIONS WILL FAR EXCEED ANY REALISTIC OR REASONABLE BENEFITS. THE TREASURY DEPARTMENT CONSERVATIVELY ESTIMATES THAT COMPLIANCE WITH THE REGULATIONS WILL ENTAIL SOME 9 MILLION HOURS OF RECORDKEEPING. COST ESTIMATES THAT I HAVE SEEN

RANGE FROM $250 MILLION TO $2 BILLION. ONE DOES NOT NEED A PHD IN ECONOMICS TO KNOW THAT THIS IS NEITHER PRUDENT ECONOMIC PRACTICE NOR DOES IT MAKE FISCAL SENSE. THE COST OF COMPLIANCE TO MY CITY COULD RUN AS MUCH AS $37,500. WHILE THIS MAY NOT SEEM TO BE A GREAT DEAL OF MONEY TO MANY LARGER JURISDICTIONS, IT CERTAINLY COULD BE PUT TO MUCH BETTER USE IN SCHENECTADY.

WHAT IS MOST BAFFLING TO ME HOWEVER, IS THAT THERE IS NO APPARENT JUSTIFICATION OR CLEAR EVIDENCE FOR THE IMPOSITION OF SUCH REGULATIONS ON STATE AND LOCAL GOVERNMENTS. WE CERTAINLY APPLAUD THE ORIGINAL INTENT OF THE LEGISLATION, NAMELY " TO DISCOURAGE EMPLOYERS FROM OFFERING HEALTH PLANS AND OTHER WELFARE BENEFITS THAT DISPROPORTIONATELY FAVOR HIGHLY COMPENSATED EMPLOYEES EITHER AS TO COVERAGE OR EXTENT OF BENEFITS," AS STATED IN THE TREASURY DEPARTMENT'S FINAL DRAFT. HOWEVER, AS IS OFTEN THE CASE, THE PROPOSED REGULATIONS REPRESENT OVERKILL AS FAR AS PERCEIVED ABUSES ARE CONCERNED. BY NOT EXEMPTING THE NATION'S 87,000 STATE AND LOCAL GOVERNMENTAL UNITS, WHERE AS I HAVE ALREADY MENTIONED THERE IS NO CLEAR EVIDENCE THAT ABUSE EXISTS, WE ARE EFFECTIVELY THROWING THE BABY OUT WITH THE BATHWATER. IT JUST DOES NOT MAKE SENSE.

TYPICALLY, STATE AND LOCAL GOVERNMENTS OFFER THE SAME BENEFITS PACKAGE TO ALL EMPLOYEES. IN A RECENT BUREAU OF LABOR STATISTICS PUBLICATION, ENTITLED "EMPLOYEE BENEFITS IN STATE AND LOCAL GOVERNMENTS, 1987" IT IS REPORTED THAT 94 PERCENT OF FULL-

TIME STATE AND LOCAL GOVERNMENT WORKERS PARTICIPATE IN AN EMPLOYER SPONSORED HEALTH CARE PLAN. NOT ONLY ARE BENEFITS EQUIVALENT AMONG SALARY LEVELS IN THE PUBLIC SECTOR, BUT THE PARTICIPATION RATES ARE EXTREMELY HIGH.

THE PRIVATE SECTOR HAS MANY MORE OPTIONS AVAILABLE TO IT FOR COMPLYING WITH SECTION 89. FOR INSTANCE, THEY CAN DROP BENEFITS ENTIRELY, SWITCH TO EMPLOYEE PAID BENEFITS OR GROSS-UP THE SALARIES OF THE HIGHLY PAID TO COMPENSATE THEM FOR ANY ADDITIONAL TAX THAT MUST BE PAID ON EXCESS BENEFITS. PUBLIC EMPLOYERS HAVE FEWER OPTIONS. BECAUSE BENEFITS ARE GENERALLY VIEWED AS A CONTRACTUAL RIGHT OF EMPLOYMENT IN THE PUBLIC SECTOR, DIMINISHMENT OR ELIMINATION IS NOT POSSIBLE. MOREOVER, BUDGET CONSTRAINTS MAKE THE GROSSING-UP OPTION FISCALLY OUT OF REACH. THUS, IN AN IRONIC TWIST, IN THE PRIVATE SECTOR WHERE THE MAJORITY OF DISCRIMINATION OCCURS, EMPLOYERS ARE IN A BETTER POSITION TO CONTINUE TO FAVOR HIGHLY COMPENSATED EMPLOYEES.

TO SAY THAT AN EXHAUSTIVE REVIEW OR READING OF THE REGULATIONS WOULD MAKE THEM LESS COMPLEX OR CONFUSING WOULD BE AN UNDERSTATEMENT OF THE GREATEST MAGNITUDE. IN FACT, THEY ARE SO COMPLEX THAT THE INTERNAL REVENUE SERVICE HAS HAD A DIFFICULT TIME FIGURING THEM OUT. UNDER THE ACT, WHICH WAS SIGNED INTO LAW IN OCTOBER OF 1986, THE EFFECTIVE DATE OF SECTION 89 WAS PLAN YEARS BEGINNING AFTER THE LATER OF (1) DECEMBER 31, 1987 OR (2) THE EARLIER OF DECEMBER 31, 1988 OR 3 MONTHS FOLLOWING THE

ISSUANCE OF TREASURY REGULATIONS. AS 1988 WANED ON INTO THE FALL, IT BECAME ABUNDANTLY CLEAR THAT SECTION 89 WOULD GO INTO EFFECT WITH NO REGULATIONS, NO PROPOSED REGULATIONS, NO RULINGS, NO ADVICE, NO NOTICES OR EVEN UNOFFICIAL GUIDANCE FROM THE IRS. AS GENERAL PANIC BECAME PREVALENT EVEN AMONG THOSE WHO HAD THOROUGH FAMILIARITY WITH THE CODE SECTION, IT WAS HOPED THAT CONGRESS, THROUGH THE TECHNICAL CORRECTIONS AND MISCELLANEOUS REVENUE ACT, WOULD AT LEAST DELAY THE EFFECTIVE DATE OF SECTION 89 UNTIL THE IRS COULD FIGURE OUT IMPLEMENTATION STANDARDS AND ISSUE REGULATIONS. INSTEAD, THE TAX LEGISLATION PASSED LAST YEAR MANDATED THAT THE IRS ISSUE REGULATIONS BY NOVEMBER 15, 1988. AS NOVEMBER 15 CAME AND PASSED, NOTHING HAPPENED.

BEGINNING EARLY IN 1989, RELIABLE PUBLICATIONS CONTINUALLY QUOTED UNOFFICIAL SOURCES FROM THE TREASURY DEPARTMENT AS SAYING THAT REGULATIONS WOULD BE ISSUED "WITHIN A FEW WEEKS". FINALLY, ON MARCH 2, 1989, AFTER TWO AND ONE-HALF YEARS SINCE THE SIGNING OF THE ACT, THE IRS ISSUED ITS 83 PAGE NOTICE OF PROPOSED RULEMAKING ON SOME, AND I REPEAT SOME, OF THE REQUIREMENTS OF SECTION 89. THE REGULATIONS, IN THEIR PRESENT FORM, DO NOT ADDRESS SUCH KEY ISSUES AS GROUP LIFE INSURANCE AND WHO MUST AND MUST NOT BE COUNTED IN DISCRIMINATION TESTING. WHAT THEY DO ADDRESS WILL UNDOUBTEDLY DRAW CRITICISM FROM EMPLOYEE BENEFIT EXPERTS.

THERE MUST BE AN EASIER WAY. WHERE THERE ARE ABUSES I WHOLEHEARTEDLY ENDORSE CORRECTING THEM. WHERE THERE ARE LOOPHOLES, THEN CLOSE THEM. HOWEVER, THIS IS LIKE DOING DELICATE SURGERY WITH A BUTCHER KNIFE. I SUPPORT YOUR EFFORTS TO BRING SANITY TO THIS ISSUE AND CAN ONLY REITERATE THAT IT MAKES LITTLE SENSE TO FURTHER HAMSTRING LOCAL GOVERNMENTS WITH COSTLY ADMINISTRATIVE MANDATES TO CORRECT A PROBLEM WHICH DOES NOT EXIST. BARRING REEXAMINATION OR OUTRIGHT REPEAL, STATE AND LOCAL GOVERNMENTS SHOULD BE EXEMPTED FROM THIS LEGISLATION.

I SINCERELY APPRECIATE THE OPPORTUNITY TO TESTIFY BEFORE THIS COMMITTEE TODAY. I WISH YOU LUCK IN THIS ISSUE AND OFFER MY ASSISTANCE, THE ASSISTANCE OF THE U.S. CONFERENCE OF MAYORS, AND THE ASSISTANCE OF THE GOVERNMENT FINANCE OFFICERS ASSOCIATION IN SEEKING A REMEDY WHICH WILL REMOVE FURTHER UNWARRANTED FINANCIAL AND ADMINISTRATIVE BURDENS ON THE NATION'S MUNICIPALITIES. THANK YOU.

NATIONAL
ASSOCIATION
of
COUNTIES

440 First St. NW, Washington, DC 20001
202/393-6226

STATEMENT OF

THE HONORABLE TERRY R. WOOD

PRESIDENT

JACKSONVILLE-DUVAL COUNTY, FLORIDA

ON BEHALF OF THE

NATIONAL ASSOCIATION OF COUNTIES

BEFORE THE

HOUSE SMALL BUSINESS COMMITTEE

ON THE IMPACT OF SECTION 89 NONDISCRIMINATION RULES

MARCH 21, 1989
WASHINGTON, DC

MR. CHAIRMAN, THANK YOU FOR THE OPPORTUNITY TO TESTIFY ON BEHALF OF THE NATIONAL ASSOCIATION OF COUNTIES.* I AM TERRY WOOD, PRESIDENT OF THE JACKSONVILLE-DUVAL COUNTY COUNCIL IN FLORIDA AND CHAIRMAN OF THE NACo PENSION AND EMPLOYEE BENEFITS SUBCOMMITTEE. BEFORE I ASSESS THE IMPACT OF SECTION 89 ON COUNTY GOVERNMENTS, LET ME FIRST SAY THAT WE HIGHLY COMMEND YOU FOR HOLDING THIS HEARING AND CALLING ATTENTION TO THE NEED TO CORRECT AN ONEROUS TAX RULE THAT ADVERSELY AFFECTS THE TAXPAYER AND DISCOURAGES THE PROVISION OF EMPLOYEE BENEFITS.

SECTION 89 WAS ADOPTED IN THE 1986 TAX REFORM ACT TO DISCOURAGE DISCRIMINATION THAT FAVORS HIGHLY COMPENSATED EMPLOYEES IN EMPLOYER PROVIDED TAX-EXEMPT BENEFIT PLANS (ACCIDENT, HEALTH AND GROUP-TERM LIFE INSURANCE). UNLIKE OUR SYSTEM OF JUSTICE WHICH ASSUMES INNOCENCE UNTIL PROVEN GUILTY, SECTION 89 ASSUMES ALL EMPLOYERS ARE GUILTY OF DISCRIMINATION

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* THE NATIONAL ASSOCIATION OF COUNTIES IS THE ONLY NATIONAL ORGANIZATION REPRESENTING COUNTY GOVERNMENT IN THE UNITED STATES. THROUGH ITS MEMBERSHIP, URBAN, SUBURBAN AND RURAL COUNTIES JOIN TOGETHER TO BUILD EFFECTIVE, RESPONSIVE COUNTY GOVERNMENT. THE GOALS OF THE ORGANIZATION ARE TO: IMPROVE COUNTY GOVERNMENT; SERVE AS THE NATIONAL SPOKESMAN FOR COUNTY GOVERNMENT; ACT AS A LIAISON BETWEEN THE NATION'S COUNTIES AND OTHER LEVELS OF GOVERNMENT; ACHIEVE PUBLIC UNDERSTANDING OF THE ROLE OF COUNTIES IN THE FEDERAL SYSTEM.

UNTIL PROVEN INNOCENT. TO DETERMINE IF DISCRIMINATION EXIST, EACH BENEFIT PLAN OFFERED BY AN EMPLOYER MUST PASS A SERIES OF HIGHLY COMPLICATED TESTS. IF DISCRIMINATION IS FOUND IN ANY PLAN, EMPLOYERS AND THEIR HIGHLY PAID EMPLOYEES CAN BE PENALIZED WITH HIGHER TAXES.

MR. CHAIRMAN, WE UNDERSTAND THAT MANY IN CONGRESS HAVE BEEN CONVINCED THAT SECTION 89 WILL EXPAND MEDICAL INSURANCE COVERAGE TO UNINSURED WORKERS. RECENT REPORTS INDICATE THAT 25 MILLION WORKING PEOPLE HAVE NO MEDICAL INSURANCE. THIS IS A DEPLORABLE FACT THAT DEMANDS IMMEDIATE ATTENTION IN FINDING A PRACTICAL, TIMELY SOLUTION. THE INTENT OF SECTION 89 IS TO EXPAND BENEFITS TO UNINSURED WORKERS, HOWEVER, WE ARE NOT CONVINCED IT WILL DO SO. INSTEAD OF ENCOURAGING EXPANDED COVERAGE, WE BELIEVE THE COMPLICATED TESTING REQUIREMENTS WILL COST TAXPAYERS MORE, UNFAIRLY PENALIZE EMPLOYEES, AND CAUSE SOME EMPLOYERS IN THE PRIVATE SECTOR TO DROP INSURANCE COVERAGE FOR SOME OR ALL OF THEIR EMPLOYEES.

TO ASSESS THE IMPACT OF SECTION 89 ON COUNTIES, LET ME BEGIN BY PROVIDING A FEW BASIC FACTS ABOUT COUNTY GOVERNMENTS. THERE ARE 3,106 COUNTIES ACROSS THE NATION THAT VARY IN SIZE, DEMOGRAPHICS AND WEALTH. ABOUT THREE-FOURTH OF ALL COUNTIES HAVE A POPULATION OF LESS THAN 50,000. OUR SMALLEST COUNTY IS LOVING COUNTY, TEXAS WHICH HAS A POPULATION OF 87, AND OUR LARGEST COUNTY IS LOS ANGLES COUNTY, CALIFORNIA WHICH HAS A POPULATION OF OVER 8 MILLION. IF WE USE THE 1986 CENSUS DATA ON THE AVERAGE ANNUAL PER CAPITA INCOME AS A MEASURE OF WEALTH, COUNTIES WOULD VARY FROM A LOW OF $3,374.00 IN STARR COUNTY, TEXAS TO A HIGH OF $23,161.00 IN FAIRFAX COUNTY, VIRGINIA.

THE MAJOR SOURCE OF REVENUE FOR MOST COUNTIES IS THE PROPERTY TAX AND IN MOST CASES WE ARE LIMITED BY STATE LAW ON THE AMOUNT THAT MAY BE ASSESSED ON AN ANNUAL BASIS. CONSEQUENTLY, THERE IS NOT A LOT OF ROOM FOR FLEXIBILITY IN OUR BUDGETS. BECAUSE OF THE LIMITATION ON OUR ABILITY TO RAISE TAXES AND A 47 PERCENT REDUCTION IN FEDERAL ASSISTANCE TO STATE AND LOCAL GOVERNMENTS OVER THE LAST 7 YEARS, MANY COUNTIES HAVE BEEN AT THEIR MAXIMUM TAXING CAPACITY FOR SEVERAL YEARS.

COUNTIES ARE NOT MERELY EMPLOYERS MR. CHAIRMAN, WE PROVIDE A FULL RANGE OF VITAL PUBLIC SERVICES TO OUR RESIDENTS INCLUDING HEALTH CARE, EDUCATION, LAW ENFORCEMENT, FIRE FIGHTING, COURTS, MAINTENANCE OF ROADS AND BRIDGES, AND NURSING HOMES. AS EMPLOYERS, WE OFFER OUR EMPLOYEES FAIR WAGES AND REASONABLE BENEFITS. IN MANY CASES WAGES AND BENEFITS ARE NEGOTIATED AT THE BARGAINING TABLE. GENERALLY SPEAKING, WE OFFER THE SAME BENEFITS TO ALL OF OUR EMPLOYEES.

IN AT LEAST 31 STATES, COUNTIES ARE REQUIRED BY LAW TO PAY FOR INDIGENT HEALTH CARE SERVICES. WE ARE ALREADY PROVIDING HEALTH CARE SERVICES TO MANY UNINSURED WORKERS THAT SECTION 89 WAS INTENDED TO ASSIST. WHILE WE CANNOT GIVE THE SPECIFIC BREAKOUT OF HOW MUCH FUNDS ARE EXPENDED FOR UNINSURED WORKERS, WE ARE CONVINCED THAT A SIGNIFICANT AMOUNT IS EXPENDED ON THESE WORKERS. WE ARE IN THE PROCESS OF CONDUCTING A NATION WIDE SURVEY TO DETERMINE THE AMOUNT OF FUNDS COUNTIES EXPEND ON HEALTH CARE SERVICES FOR INDIGENT WORKERS AS COMPARED TO OTHER INDIGENTS. WE WOULD BE HAPPY TO SHARE THE RESULTS WITH THE COMMITTEE WHEN THE SURVEY IS COMPLETE.

AS SERVICE PROVIDERS, WE SPEND A SIGNIFICANT AMOUNT OF OUR REVENUES EACH YEAR TO PROVIDE HEALTH CARE TO THE UNINSURED. HEALTH CARE FOR THE UNINSURED IS ONE OF the HIGHEST, IF NOT THE HIGHEST, COSTS FOR COUNTY GOVERNMENTS. THE 1986 CENSUS DATA SHOWS THAT COUNTIES SPENT $14.9 BILLION ON HEALTH CARE SERVICES. IT ALSO IDENTIFIES $7.2 BILLION IN UNCOMPENSATED HEALTH CARE COSTS FOR HOSPITAL SERVICES. WHILE THESE COSTS REPRESENT THE TOTAL LOSS FOR PUBLIC AND PRIVATE HOSPITALS, IT IS SAFE TO ASSUME THAT THE MAJORITY OF THESE COSTS WERE BORNE BY COUNTY HOSPITALS SINCE PRIVATE HOSPITALS REFER MOST UNINSURED PATIENTS TO US.

LET ME ASSURE YOU THAT NO ONE IS MORE INTERESTED IN RESOLVING THE UNINSURED INDIGENT PROBLEM THAN COUNTY GOVERNMENTS WE FEEL VERY STRONGLY THAT THE PROVISION OF HEALTH CARE SERVICES TO THE UNINSURED MUST BE ACCOMPLISHED THROUGH SHARED RESPONSIBILITY BETWEEN THE COUNTY, STATE AND FEDERAL GOVERNMENT, AND THE PRIVATE SECTOR. COUNTIES SPEND BILLIONS OF DOLLARS ANNUALLY ON THE UNINSURED. WE FEAR THAT SECTION 89 WILL CAUSE STATES AND LOCALITIES TO DIVERT FUNDS FROM BADLY NEEDED PUBLIC SERVICES TO PAY EXPENSIVE CONSULTING AND LEGAL FEES MERELY TO FIGURE OUT HOW TO PASS A SERIES OF COMPLICATED TESTS.

LOCAL GOVERNMENTS HAVE HISTORICALLY OFFERED SIMPLE UNIFORM BENEFIT PROGRAMS TO BOTH THEIR ELECTED AND CIVIL SERVICE EMPLOYEES. IN MOST CASES THEY DO NOT REMOTELY RESEMBLE THE PLANS OFFERED BY THEIR PRIVATE SECTOR COUNTERPARTS. THE BUREAU OF LABOR STATISTICS FOUND IN A 1987 SURVEY, THAT 94 PERCENT OF FULL-

TIME EMPLOYEES IN STATE AND LOCAL GOVERNMENTS HAVE MEDICAL INSURANCE COVERAGE AND 85 PERCENT HAVE LIFE INSURANCE COVERAGE. THE SURVEY ALSO SHOWS, IN THE MAJORITY OF CASES, PUBLIC EMPLOYERS PAY THE FULL COST FOR INDIVIDUAL EMPLOYEE COVERAGE. IN 27 PERCENT OF THE CASES, WE PAY THE FULL COST FOR FAMILY COVERAGE, AND AN ADDITIONAL 66 PERCENT OF THE CASES, WE PAY A PORTION OF THE COST FOR FAMILY COVERAGE.

WHILE THE FULL FINANCIAL IMPACT OF SECTION 89 ON THE PUBLIC SECTOR WILL NOT BE KNOWN FOR SOME TIME, WE BELIEVE THE COST OF COMPLIANCE WILL BE IN THE HUNDREDS OF MILLIONS. IN MY AREA ALONE, WE ARE ESTIMATING THAT THE COST OF COMPLIANCE FOR THE FIRST YEAR WILL EXCEED $250,000.00 FOR STAFF, CONSULTANTS, COMPUTER EQUIPMENT AND CONTINUOUS ADMINISTRATION. INSTEAD OF SPENDING THESE FUNDS ON CONSULTANTS AND LAWYERS, I AM SURE YOU WILL AGREE MR. CHAIRMAN, IT WOULD MAKE MUCH MORE SENSE TO USE THESE FUNDS TO PROVIDE VITAL PUBLIC SERVICES, INCLUDING HEALTH SERVICES TO THE UNINSURED.

FURTHERMORE, THE COST OF COMPLIANCE IN THE PUBLIC SECTOR COULD MEAN A SUBSTANTIAL INCREASE IN COSTS TO TAXPAYER. UNLIKE THE PRIVATE SECTOR, THE COST OF PERSONNEL AND OTHER EXPENSES RELATED TO PUBLIC SECTOR COMPLIANCE, WILL BE DIRECTLY BORNE BY TAXPAYERS. ANNUAL COMPLIANCE REVIEWS, EVEN FOR SMALLER COUNTIES HAVE BEEN ESTIMATED IN THE RANGE OF $5,000.00 FOR SMALL COUNTIES AND $250,000.00 AND ABOVE FOR LARGE COUNTIES SUCH AS DUVAL. USING THESE FIGURES TO DEVELOP A ROUGH ESTIMATE OF THE TOTAL COST OF COMPLIANCE WITH SECTION 89 IN THE PUBLIC SECTOR, WE BELIEVE WE WILL BE REQUIRED TO EXPEND $435 MILLION.

IN SUMMARY, MR. CHAIRMAN, STATE AND LOCAL GOVERNMENTS SHOULD BE EXEMPT FROM SECTION 89. THERE IS NO EVIDENCE OF DISCRIMINATION IN PUBLIC SECTOR BENEFIT PLANS AND WE ARE ALREADY SPENDING A SIGNIFICANT PORTION OF OUR REVENUES TO PROVIDE HEALTH CARE TO UNINSURED INDIGENTS. IT IS EXTREMELY UNFAIR TO SADDLE OUR TAXPAYERS WITH THESE ADDITIONAL COSTS UNDER THE GUISE OF EXPANDING BENEFITS TO THE UNINSURED, PARTICULARLY WHEN ALMOST ALL OF THE ADDITIONAL COSTS IN THE PUBLIC SECTOR WILL BE RELATED TO CONSULTANTS AND LAWYERS FEES.

PUBLIC SECTOR EMPLOYERS ARE EXEMPT FROM THE EMPLOYEE RETIREMENT INCOME SECURITY ACT, AND WE ARE TREATED DIFFERENT FROM THE PRIVATE SECTOR IN THE FAIR LABOR STANDARDS ACT BECAUSE WE DO NOT DISCRIMINATE IN PROVIDING BENEFITS TO OUR EMPLOYEES. WE ARE SUBJECT TO THE SAME PUBLIC SCRUTINY AS STATE AND FEDERAL OFFICIALS, AND WE ARE NOT IN BUSINESS TO MAKE A PROFIT BUT TO SERVE PEOPLE. FOR THESE REASONS, WE URGE YOU TO EXEMPT STATES AND LOCALITIES FROM SECTION 89.

MR. CHAIRMAN, THANK YOU FOR THE OPPORTUNITY TO TESTIFY. I WOULD BE HAPPY TO ANSWER ANY QUESTIONS AT THE APPROPRIATE TIME.

TESTIMONY TO
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

HEARING ON INTERNAL REVENUE CODE
SECTION 89

MARCH 21, 1989

PRESENTED BY

FREDERICK R. FORD
EXECUTIVE VICE PRESIDENT AND TREASURER
PURDUE UNIVERSITY
WEST LAFAYETTE, INDIANA

Mr. Chairman, Ladies and Gentlemen:

Thank you for the opportunity to appear today before the Committee on Small Business of the House of Representatives.

My name is Dr. Frederick R. Ford, Executive Vice President and Treasurer of Purdue University. I am here to represent the many colleges and universities in this nation who are attempting to comply with the intent of Section 89 of the Tax Reform Act of 1986. In particular, I will try to assess the impact of Section 89 on colleges and universities and the specific burdens that the nondiscrimination testing requirements impose on them.

Purdue is one of this nation's federal land grant institutions with an enrollment of more than 52,000 students on 4 campuses. For your information, Purdue has awarded more bachelor degrees in engineering than any other university in this nation. In the number of Ph.d's awarded, Purdue ranks 2nd in the nation in pharmacological sciences, 7th in engineering, and among the top 5 in chemistry. Purdue's School of Veterinary Medicine is one of only 27 in the United States. I think it is fair to say that Purdue, along with more than 3,500 other colleges and universities, both public and private, provide the citizens of this country with essential teaching, research, and public service needs required to keep the nation moving forward.

Colleges and universities are not made of mortar and machinery, but of people dedicated to the educational process. For example, at Purdue University, our total faculty and staff employment numbers 13,244. But a great number of our employees are students attending the University in pursuit of their own educational endeavors. We have, for instance, 777 graduate instructors, 1,367 graduate teaching assistants, 940 graduate research assistants, 169 fellows, and 245 student administrative. In addition to that, nearly 7,000 undergraduates work in our kitchens, offices and laboratories through work study programs and other student employment efforts intended to, at least in part, offset their educational expenses.

While my comments are based on our experiences at Purdue University, they are applicable generally to colleges and universities across this nation and I am, therefore, speaking today on their behalf also.

I am happy to say the Technical Corrections Act passed by Congress in late 1988 excluded student employment from Section 89 rules, provided that no social security tax was withheld for these individuals and that core health coverage is available. I want to thank the Congress on behalf of Purdue and other colleges and universities for this thoughtful and intelligent effort on the part of the Congress to protect student employment at our various institutions. I would be remiss, however, if I did not point out to you, again, the provision that accompanies the student exclusion, which is that no social security tax be withheld. So long as Congress does not change its position in this regard, we feel that the exclusion is workable. I am disturbed, however, by occasional reports I receive that Congress might change its position regarding social security withholding from student wages. I believe that all colleges and universities would feel more certain if the exclusion for students from Section 89 was based upon their enrollment, without regard to social security withholding. The inclusion of students for Section 89 testing purposes would cause most of the nations 3,500 institutions to fail the tests outright. The financial impact of such a possibility would be enormous.

Now, if I may, let me turn to the more technical aspects of Section 89 and its impact.

We support the concept that tax-favored benefits should not discriminate in favor of highly compensated employees. However, our objections to Section 89 extend far beyond the issue of whether or not benefits should be discriminatory. These objections can be summarized as follows:

- Section 89 punishes employers whose employees fit within certain fact patterns. It also punishes employers who cannot allocate the resources necessary to understand, gather, and manipulate the data needed under Section 89. Thus, although Section 89 takes aim at discriminatory plans, it affects many employers who are innocent bystanders.

- Section 89 is deceptively easy to describe but difficult to truly understand and to apply. It is simple to stand here and describe the requirements of Section 89. However, the efforts necessary to understand the hidden complexities and to comply with Section 89 are extraordinary and should not be underestimated because of the superficial simplicity of Section 89.

- Section 89 is a massive diversion of resources, yet generates questionable results. Section 89 will require Purdue and other employers to spend significant sums and invest substantial amounts of employees' time. Yet benefit programs designed to reflect employer and employee needs will for the large part be unchanged.

- Section 89 imposes a narrow and rigid view on "approved" benefit designs and fails to reflect the advantages of employer flexibility and employee choicemaking.

Allow me to describe these concerns in greater detail.

1. Section 89 does Not Only Punish Discrimination. To say that Section 89 punishes discriminatory benefits is to say that runners who do not finish marathons are lazy. Although Section 89 is designed to punish discriminatory benefits, there are many ways to fail Section 89 that have nothing to do with discrimination. Here are some examples:

- Over 80% of Purdue's highly compensated employees elect family medical coverage, while under 60% of Purdue's nonhighly compensated employees elect family coverage. Is our benefit discriminatory? Our price structure is the same for all employees. Thus, our results may be based on the fact that more of our nonhighly compensated employees are unmarried or have working spouses with their own employer-provided benefits. Yet, unless Purdue drafts, prints, distributes, and collects detailed sworn statements from virtually all of its employees, it will fail the average benefits test under Section 89.

- Some universities do not provide benefits to visiting lecturers. On the other hand, some universities must provide special programs to visiting professors in order to prevent gaps in medical coverage. Both of these practices can result in failing various Section 89 tests. Should these programs be penalized?

- There are hospitals, including university hospitals, with two categories of nurses--those who are regular employees and who receive benefits, and those who have elected a higher hourly wage in exchange for a more flexible schedule and no benefits. Yet these hospitals fail the 90/50 eligibility test. It there something wrong with this program that should be penalized?

Section 89 punishes many employers and employees for programs that have nothing to do with discrimination. Moreover, the indiscriminate impact on the Section 89 rules is not alleviated by some cosmetic technical changes to Section 89.

2. Section 89 is Perceptively Difficult to Understand and Apply. It is easy to state the Section 89 rules. In many cases, it is relatively easy to pass the Section 89 tests. Thus, Section 89 may not seem quite as bad as the testimony today makes it seem. However, do not underestimate Section 89. Although the basic tests are easily described, there are literally hundreds of secondary rules that accompany the basic tests. These rules constitute an interpretive and administrative nightmare. Some examples--

- Purdue, like many other colleges and universities, maintains a variety of accident and health plans, with various coverage levels. The 50% test under Section 89 requires us to analyze this structure as over 100 plans. The recently released proposed regulations contain additional requirements regarding plan aggregation that further expand the number of plans to be tested.

- As noted earlier, there are rules regarding employees' sworn statements and the tracking of part-time employees' hours that are supposed to ease the application of Section 89. Although employers appreciate the Congressional desire to help, these "breaks" under Section 89 place employers in the awkward position of choosing between incurring significant additional administrative costs or failing the tests.

One problem we face with applying the Section 89 rules is the lack of clear and complete guidance. The recently issued IRS regulations are over 200 pages long yet fail to address some of the major Section 89 questions such as how to apply the rules to group term life plans and to former employees.

There are those who have said that employers who complain about Section 89 have not tried to apply the tests. It is not employers who have not tried. Instead, it is those who favor Section 89 who have not tried--they have not observed employers incurring fees and dedicating resources to meeting Section 89, they have not listened to the difficult questions posed for which there are no meaningful answers, and they have not appreciated the efforts necessary to apply the hundreds of secondary rules under Section 89. The Paperwork Reduction Act estimates for the recently released Section 89 regulations estimate that employers will spend an average of 10 hours in learning and applying the tests. This estimate is wrong by hundreds of hours.

You will hear much testimony about how difficult it is to apply Section 89. The basis for these complaints lies in the data needs created by Section 89. In order to apply the Section 89 tests, an employer must maintain at least 50 different pieces of information about each employee. This information must identify the employee, the plans he or she is eligible for, and the plans he or she participates in. This information must not only be maintained--it must be maintained on a computerized data base that can be tested. Moreover, the employee data must be supplemented by plan data. This plan data must relate to the employee data, so the employer can determine which employees are eligible for each plan and which employees participate in each plan. The problems inherent in obtaining, organizing, and analyzing this data are staggering.

Here, too, these problems are inherent in the structure of Section 89. Attempts to merely tinker with the Section 89 rules are not likely to decrease the amount of employee data that must be maintained.

3. Section 89 is a Massive Diversion of Resources. Purdue will have to spend tens of thousands of dollars in obtaining the assistance necessary to meet the requirements of Section 89. It will have to dedicate hundreds of hours of employees' time in order to obtain and analyze the necessary data. And what will be the result of this effort? Purdue anticipates that it will pass the Section 89 tests. Thus, the investment required under Section 89 will serve only to prove compliance with Section 89. But look at the costs. The out-of-pocket expenses to meet Section 89 are significant. And internal resources will have been diverted from their tasks--the design, implementation, and administration of our employee benefit programs. The increased expenses will have to be covered largely through increased student fees. Not a happy result at a time when many feel that student fees are already increasing too rapidly.

4. Section 89 Limits Employee Benefits. Employees want a range of benefits and then want the right to exercise control over their choice of benefits. Employees' needs change, and they want their benefits to respond.

Section 89 hampers employer's ability to address these employees' needs. An employee may want to select an inexpensive catastrophic accident and health plan and use the savings for other purposes. Yet if the employee is nonhighly compensated, the employer's Section 89 results suffer.

The Section 89 rules impose a rigid viewpoint of what benefit designs are "deserving" of tax-favored treatment. This rigidity is inherent in the basis structure of Section 89, and the problem is not resolved by token attempts at simplification. As in the case of each of my concerns, Section 89 causes problems that can be eliminated only by significant simplification.

Conclusion

Purdue and the other colleges and universities will gladly participate in any efforts to further the policy goals behind Section 89. However, the basic structure of Section 89 is so burdensome and Section 89's ability to further these goals is so questionable in its current form, that I must urge the Committee to repeal or drastically revise the rules to take into account the many problems outlined above. We need rules that will give us the flexibility to develop employee benefit plans to best serve our employees; rules that will allow us to know that plans are nondiscriminatory because of their design. In this way, we can hold costs down and, therefore, minimize the impact on student fees.

March 16, 1989

STATEMENT OF SAMARITAN HEALTH SERVICES
Howard Rohan, Vice President, Human Resources
(House of Representatives - Committee on Small Business)

Samaritan Health Services is the fifth largest secular non-profit, multi hospital health care system in the United States and is the fourth largest employer in the state of Arizona with 9,561 employees.

It is unnecessary in this statement to site the history and details of Section 89 of the Internal Revenue Code. Suffice it to say that it is a section which became effective on January 1, 1989 with the objective of diminishing the likelihood of highly compensated employees receiving welfare benefits in a discriminatory fashion. In preparation for implementation of the various testing requirements in Section 89, Samaritan began reviewing Section 89 announcements in 1988. While there is merit in ferreting out and attempting to reduce discriminatory practices in the design and administration of welfare benefits, Section 89 is clearly overkill on the part of the tax writers in Congress.

Undoubtedly, the committee has heard considerable testimony about the problems that industry in general faces in complying with Section 89. However, there are problems that are peculiar to the non-profit industry and these are the issues that we wish to address. From a practical standpoint, the following from the implementation of Section 89:

* Increased costs because of the high utilization of part time employees in meeting staffing needs at the hospitals.

* Increased costs because of the high usage of leased employees (registry personnel) to meet critical staffing needs.

* Increased cost of health care to the patient through higher charges or though lower quality of care.

* Increased administrative costs

1. High Utilization of Part Time Employees

Hospitals do not operate 8 hours a day, 5 days a week. We operate 24 hours a day, 7 days a week, 365 days a year. Staffing needs ebb and flow depending upon varicus

seasonal factors. To meet these staffing requirements, a variety of work schedules are required.
In February 1989, we had 9,561 employees. Of these, 7,447 worked 32 hours or more per week - our definition of full-time work. The rest, 2,114 or 22.1% of our work force worked less than 32 hours per week. Some worked a regularly scheduled number of hours. Others were "on call" and worked when demand called for their services. These hours are as low as 8 per week.

Are these employees working less than full-time because they want to or because they are forced to? As the committee well knows, there are critical shortages of health professionals throughout the country. Those who want full-time employment can readily find it. The more than 1 in 5 of our employees working less than full-time do so by choice. This is a supplemental work force, critical to hospital operations.

Our need for these employees fluctuates dramatically over time. In our part of the country, our needs are greater in the winter months than in the summer months. But, even within these peaks and valleys there are peaks and valleys. For the most part, our less than full-time employees are not primary wage earners. While we offer to them the opportunity to enroll in our health benefit programs, most decline to do so. The reason is obvious--coverage is available elsewhere, either through a spouse or through other employment. Yet, compliance with Section 89 would require us to provide such benefits even though they are not wanted or needed. This would increase our welfare benefit cost significantly. Which in turn raises the question of whether to eliminate this supplemental work force.

2. High Use of Registry Personnel

The staffing needs of hospitals presents a further problem. To meet peak demands or, and this is becoming increasingly important, to obtain the services of employees whose skills are in a critical shortage, we must frequently lease employees. This is particularly common among non-profit hospitals in staffing of nurses. While such leased employees are really not our employees, Section 89 imposes upon us onerous requirements to take such employees into account in order to complete discrimination testing. This adds to our costs and fails to recognize the obvious, i.e., leased employees are working where they are working because that is what they want to do. In fact, many of those registry employees are employed full time in hospitals and work through the registries to supplement income.

3. Increased Costs to Patients

Like any non-profit organization, hospitals exist to serve the public. We recognize that it is in society's interest that employee welfare plans benefit the many and not the few. It is wrong both ethically and legally for value to inure to highly compensated employees. But, we must spend thousands of dollars to prove that we don't. This has a two-fold impact. First, we can try to pass this cost on to our patients. However, in this era of fixed price contracts; e.g., Medicare and Medicaid, this may not be possible. If we cannot pass on this cost, then we must turn to our second alternative, reducing the services we provide. Are either of these alternatives desirable? No! Because of the limited dollars available in health care, Section 89 may very well prompt the elimination of benefits to these employees.

4. Increased Administrative Costs

Section 89 significantly increases costs in benefit administration. The law is exceedingly difficult to administer and already is requiring allocation of present staff to run tests for compliance, not to mention what is in store for us down the road. The initial evaluation of various benefit plans by staff, outside consultants and legal counsel is but the beginning. It will be necessary to spend thousands of dollars to continue the evaluation, audit the plans, change computer systems, and probably redesign existing plans. At Samaritan, we estimate a $40,000 cost for initial testing only. But when you consider the potential effect the regulations will have on continued administration of our various plans, that figure is probably in excess of $100,000. Multiply this cost by the 100 or so hospital systems in the country and by the several thousand non-profit hospitals, and the cost of health care is seriously impacted.

Finally, do we need this kind of mechanism to do what the tax writers in Congress are trying to do--get at discrimination in welfare benefit plans. It seems they are trying to solve a revenue problem but in the process have laid the ground work for a costly social problem with little revenue impact. Section 89 makes it expensive and impractical to employ part time people. It is that simple. Yet, the non-profit health care industry relies heavily on the part time employee to supplement the normal working staff. It is the supplemental worker who brings home the additional income to provide families with needed income. Along with the severe cost impact to our industry, the issue of the supplemental worker may well be as serious a problem.

Conclusion

The whole thrust of Section 89 negatively impacts the primary mission of non-profit hospitals which is to provide quality health care at affordable costs. We are in a severe financial environment which challenges the very best of hospital management to operate effectively and efficiently. Compliance with Section 89 adds direct and indirect costs to hospital operations and in turn effects our ability to achieve these objectives.

Recommended Relief

With respect to a recommended relief, we make an appeal to this Committee to get the message to the tax writers regarding the serious problems facing our industry. Report this analysis to them and encourage them to work for meaningful relief on this piece of legislation. This legislation is not working. It has laid a tremendous financial burden on our industry and rest assured it will bring on problems not anticipated when this regulation was written. It is incumbent upon those in position to influence change to be kinder and gentler than this regulation has turned out at this point. Short of repealing Section 89, it needs to be deferred and redrafted.

aspa
Managing Human Resources

TESTIMONY OF GARY B. KUSHNER

EMPLOYEE BENEFITS CONSULTANT

AND

PRESIDENT
KUSHNER AND CO., INC.
KALAMAZOO, MICHIGAN

ON BEHALF OF

THE AMERICAN SOCIETY FOR PERSONNEL ADMINISTRATION

BEFORE THE

SMALL BUSINESS COMMITTEE
OF THE
U.S. HOUSE OF REPRESENTATIVES

MARCH 21, 1989

American Society For Personnel Administration
National Headquarters • 606 N. Washington Street • Alexandria, Virginia 22314 • Phone: 703/548-3440

Mr. Chairman and members of the Committee, my name is Gary Kushner. I am President of Kushner and Co., Inc., a national employee benefits consulting and administration firm in Kalamazoo, Michigan, and I also serve as the Chairman of the Compensation and Benefits Committee for the association I am representing here today, the American Society for Personnel Administration (ASPA). ASPA is the world's largest professional society devoted exclusively to excellence in human resource management. The Society's membership has grown to more than 40,000 since its founding in 1948. ASPA represents individuals employed by companies which collectively employ more than 41 million people and includes managers from a cross-section of American business -- from large corporations to smaller family operations -- as well as governmental entities and not-for-profit firms.

On the front lines as practitioners, innovators, managers and decision-makers, human resource professionals are challenged to balance our companies' need for administrative cost-effectiveness with our employees' desire for fair and comprehensive welfare benefit plans. Human resource managers are in a unique position to provide practical guidance on employee benefit issues, and we encourage employers to offer competitive and diverse benefits packages. Therefore, you can understand why I am more than happy to appear before this committee on the subject of Section 89, and

I applaud your efforts to repeal this onerous law.

I would like to start off by emphasizing the fact that ASPA supports the Congressional intent behind Section 89. We agree that Congress should discourage employers from abusing the tax favored status of health and group term life benefits by reimbursing their highly paid employees with a disproportionate share of benefits.

However, as one who deals with employee benefit plans every day, I would like to assure you that, in trying to accomplish this goal, Congress has created a law that is so complex, and imposes such substantial administrative burdens on employers, that it is a very effective impediment to employers who wish to expand the diversity and scope of their employee benefit coverage. The much anticipated Section 89 regulations, which were so difficult to draft that they were issued almost four months behind schedule by the IRS, provide little relief from, and even less clarification of, a law which took effect on January 1 of this year.

Section 89 is driving plan sponsors to either simplify their plans by reducing health benefit options and cutting back on subsidized family health coverage, or simply eliminating health coverage benefits for employees. For this reason, we believe that repeal of Section 89 is the only available option for Congress to relieve employers of its unrealistic administrative burdens. We would encourage Congress to use Section 89's repeal as an opportunity to come up with a better way of meeting its laudable goals, an effort in which ASPA will be happy to assist.

As we know, Section 89's regulations were finally published on March 7. However, I do not believe that many plan sponsors are any closer to a clear understanding of exactly what the new law entails. The regulations, as the IRS is quick to point out, do contain transitional relief for many of the law's less complex qualification rules, and they even relax compliance standards for the complicated non-discrimination tests in 1989. But the regulations do little to reduce the law's burdensome data collection and testing requirements.

In a few cases the IRS uses the transition rules contained in the regulations to actually make the testing requirements more complicated, and, in at least one case, even seems to exceed its statutory authority. For example, the regulations appear to require the 50% eligibility test as a prerequisite to using the 80% alternative coverage test, a provision not included in the original statute or its legislative history.

While the IRS provided some relief to a few employers of over 5,000 employees, it gave no such assistance to the small business community, which, because it lacks the necessary resources, will have a more difficult time with compliance. It is interesting to note that this particular relief provision might conveniently apply to the Federal government, thereby exempting it from testing. Additionally, the regulations do not include much-needed guidance on group term life insurance plans, excludable employees, leased employees, separate lines of business, and multi-employer plans.

To comply with Section 89's regulations, employers must first establish that their plans conform to Section 89's qualification standards. They must then gather data and conduct the complicated statistical tests for every coverage option available to any employee. This means that single and family coverage options, all health and other applicable options under flexible benefit plans, and all employee contribution and coverage levels must be treated as individual plans. Applying actuarial standards, the employer must determine the value of each plan, as well as the number of employees eligible for testing and the number of employees who are "highly compensated". The employer is even required to obtain sworn affidavits, submitted under penalties of perjury, from employees regarding their coverage under other plans and their marital and dependent status. The employee- relations impact of this provision is deplorable.

To avoid additional taxes, the employer must prove that each separate plan option can pass statistical tests requiring that certain percentages of "non-highly compensated" employees receive acceptably high values of benefits as compared to their "highly compensated" colleagues. Unbelievably, a plan can be deemed discriminatory if a proportion of lower paid employees choose not to participate, even if all employees are offered equal access to the plan. This has a tremendous impact on smaller employers, since any individual employee represents a large percentage of their workforce.

What does all of this mean to employers? One ASPA member has told us that his company will face first year compliance costs of $3,000 for in-house staff time and $20-25,000 for outside consultant fees to assist in actuarial valuation and statistic evaluation of its plans. It will face second year costs of $3,000 for software and an additional $3,000 for training an in-house expert on Section 89.

What does this mean to its employees? In this case, Section 89 is forcing his company to delay, perhaps indefinitely, the implementation of a planned employee flexible benefit plan.

An ASPA member of a smaller company was not able to find any outside consultant assistance on Section 89 for less than $7,500. Yet another's company will be forced to scrap its diversified benefits structure and return to its pre-1985 single health plan option for all its employees.

Speaking as a consultant, I perceive Section 89 as a regulatory "mine field". There are so many potential pitfalls and penalties contained in the complicated regulations for an employer who offers anything other than the most basic health benefits package to its employees that some consultants are advising their clients, especially small business owners, to reduce or terminate health care coverage to their employees. It is simply not worth the risk, and is the easiest and least expensive Section 89 compliance method. To make matters worse, Section 89 is entering the picture at a time when health care costs are rapidly escalating, with costs to employers increasing 30%, 40% or even 50% per year.

Many employers are angry that they will have to spend considerable sums of money merely to prove what they knew all along -- that their plans are not discriminatory. Others are angry that they are being penalized for offering extensive, diversified benefit packages which best meet their employees' needs.

The end result of Section 89 is the exact opposite of Congressional intent: employers will reduce or eliminate heal care coverage to employees. What I don't understand is why Congress, when it is supposedly so concerned for those who lack adequate health insurance that it is even considering a mandate on employers to provide such coverage, would pass a law which is so difficult to administer that it could effectively reduce the degree of employer health care coverage offered today and in the future. Now that the unworkable nature of this law is apparent, I am confident that Congress will recognize this error, and repeal it forthright.

As I mentioned, if Congress perceives that the issue of discrimination in employee benefit plans needs to be addressed, ASPA is available, and is very willing, to assist Congress its efforts.

Mr. Chairman, I present the following ideas only as constructive suggestions for how Section 89 could have been made less burdensome to employers, not as alternatives to your repeal efforts:

- o Congress should exclude collectively bargained plans from testing.
- o Passage of Section 125 tests should be made a safe harbor

for Section 89 purposes, instead of requiring separate tests for every coverage option available under those types of plans.

- Employers should be allowed to consider employee-only and family coverage options under the same benefit structure as the same plan, and Congress should eliminate the sworn statement requirement.
- The designation of relatively minor benefits, such as accidental death and dismemberment and business travel accident benefits, as de minimis fringe benefits which would not require testing could considerably reduce testing obligations.
- Congress should also designate a higher threshold for part time workers. It is an unfortunate fact of life that setting a low part-time threshold does not protect the part time worker; it merely discourages the employer from maintaining or creating positions which exceed the minimum hours-per-week definition.
- Do not allow exemptions for the Federal government, including the legislative branch. If Congress and the Federal government itself have to do this testing even once, they will get a flavor for what other employers are up against.

I commend Congress for trying to encourage employers to broaden benefit coverage to all their employees. But, clearly, Section 89 has failed to achieve that goal, and instead will have a deleterious effect on employee benefits.

I thank you for the opportunity to testify here today, and I would be happy to answer any questions the committee might have.

the Principal Financial Group

Federal Government
Relations Office

STATEMENT OF

THE PRINCIPAL FINANCIAL GROUP

SUBMITTED TO

THE COMMITTEE ON SMALL BUSINESS, HOUSE OF REPRESENTATIVES

REGARDING IMPACT OF INTERNAL REVENUE CODE SECTION 89

MARCH 21, 1989

Suite 950, 655 Fifteenth St. N.W., Washington, DC 20005. (202) 737-5930 / FAX (202) 628-2910
Home Office: Des Moines, Iowa 50309. (515) 247-5111

Mr. Chairman, I am Ron Danilson, Associate Director - Group Underwriting with responsibility for product development and legislative compliance activities for The Principal Financial Group headquartered in Des Moines, Iowa. The Principal is a major underwriter of employer sponsored life and health insurance and provides coverage for over 60,000 employer groups located throughout the United States. Of this number, some 50,000 are employers with 10 or fewer covered employees whose plans include approximately 360,000 employees and their dependents. I appreciate your invitation to participate in this hearing and to have the opportunity to share with you some of our concerns and our experiences in assisting our small employer customers with Section 89.

I'll limit my oral statement to only those areas of major concern for our small employer customers. I would ask, Mr. Chairman, that you refer to the written statement The Principal submitted for the hearings held in January for additional details.

1. We are convinced the nondiscrimination tests are too onerous and that their attendant rules of application are too complex for small employer group plans. Unless the rules are simplified so that small employers are able to understand and apply the tests, many so-called discriminatory plans will result. Many of our customers are overwhelmed with the law's complexity, they tell us they will simply have the business owner pay the tax rather than attempt to collect data and apply the tests. We are also beginning to receive letters from small employer customers who are dropping their plans specifically because of Section 89. Rules that are considered difficult for benefit experts to understand are incomprehensible for small employers without full-time benefits staffs or without the resources to hire benefits professionals.

2. Section 89 artifically imposes a new definition of part-time employee of 17 1/2 hours per week on all employers and requires these employees be counted in testing. For many of our small business customers, this boils down to a forced financial choice of paying tax on their own benefits since the cost to expand coverage to all part-time employees is a significantly greater financial burden. Small business owners who have voluntarily taken steps to provide health benefits to full-time employees may now be penalized by Section 89 for failing to cover part-time employees, when Congress has yet to decide on how best to encourage more employers to provide health coverage to their full-time workers. A phase-in of part-time workers for the 80% test was included in last year's technical corrections as a result of the efforts of Senator Tom Harkin and Senator Charles Grassley. This phase-in should be expanded to apply to all tests.

3. A common characteristic of small employer plans, because of their limited financial resources, is a less generous employer subsidy for dependent coverage than is provided for the employee's coverage. The mechanics of Section 89 will require many small employers to take the additional step of testing the dependent coverage separately in order to pass. Even though the subsidy is uniform for all employees, the affordability issue may cause difficulties in passing the tests. One practical alternative, confirmed by some of our own customers' actions, is dropping the subsidy for dependent coverage for all employees.

4. The new regulations issued recently add to the burdens of small employers rather than simplify the rules. Historically, small employers have been required to satisfy the written plan rules prescribed by

ERISA. The new regulations add a new layer of requirements on top of existing ERISA rules with little substantive difference in the end result. These new requirements will force small employers to incur additional expense for a new "single written plan document" and employee notice. Furthermore, the regulation requiring a single written plan document appears in direct conflict with the conference agreement on qualification requirements included in the Technical and Miscellaneous Revenue Act of 1988. Although employers have until their 1990 plan year to satisfy the plan document rule, a July 1 deadline provides little time to satisfy the new notice rules.

At The Principal Financial Group, we are helping our small employer customers cope with Section 89 in a number of ways:

1. We've established a toll-free number for both our customers and their agents to call for help with Section 89 questions. We received nearly 2,800 calls in the first two months of operation. The questions range from very basic to complex, but reinforce our view that the complexity of Section 89 is contributing to a widespread lack of understanding on the part of small employers.

2. We are also providing our customers and their insurance agents with educational question and answer materials and an informational packet designed to help them collect employee data and apply the tests. We're also offering testing services.

As I indicated earlier, some policyholders are terminating their group plans rather than face the task of compliance. Others are considering this alternative. One customer with nine employees in Dayton, Ohio terminated his group plan and gave each employee an additional $1,500 in pay to go and find their own health benefits. Other examples of statements from policyholder letters include:

- A five employee mining company in Arizona: "Our decision to cancel our Group Coverage was prompted by the IRS Section 89 legislation."

- A nine employee hardware store in Florida: "Our cancellation is due to IRS ruling #89 which makes it necessary to cancel this company benefit."

- A 19 employee company in Rhode Island: "The administrative requirements and penalty clauses of Section 89 of the IRS code are too excessive to make continuation of this policy practical."

As we pointed out in our January 25 statement, we think a more appropriate alternative to discrimination testing for small employer groups is a safe harbor plan design. The advantages of allowing small employers to satisfy Section 89 by virtue of plan design, rather than complicated testing, far outweighs the disadvantages. The small group safe harbor represents a reasonable middle ground that would promote modest coverage expansion through broader availability of benefits. Most importantly it allows the small employer to avoid the costly and time-consuming task of applying the complex Section 89 tests. We are also working with the Section 89 coalition to develop other simplification proposals for consideration by The House Ways and Means Committee.

the Principal Financial Group

Federal Government
Relations Office

STATEMENT OF

THE PRINCIPAL FINANCIAL GROUP

SUBMITTED TO

THE COMMITTEE ON SMALL BUSINESS, HOUSE OF REPRESENTATIVES

REGARDING IMPACT OF INTERNAL REVENUE CODE SECTION 89

JANUARY 25, 1989

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Background

The Principal Mutual Life Insurance Company is headquartered in Des Moines, Iowa. We are a major underwriter of life and health insurance for employer groups located throughout the United States. Our current policyholders include over 50,000 employers with fewer than ten full-time employees each. The programs sponsored by these employers provide coverage to approximately 363,000 employees and their dependents. The typical small employer health plan has these characteristics:

1. A single common schedule of benefits available to all employees (highly compensated and nonhighly compensated) and their dependents.

2. Eligibility limited to full-time employees and their dependents (full-time defined as 25 or more hours per week) who submit satisfactory evidence of insurability.

3. Employer/employee cost sharing - employers generally pay all or a part of employee premium - employees generally pay all or a part of their dependent's premium.

Purpose

The Tax Reform Act of 1986 added Section 89 to the Federal Internal Revenue Code. Section 89 contains nondiscrimination tests that apply to all group life and health plans. These tests are intended to discourage (via tax penalties) plans that:

1. do not extend coverage to classes of employees traditionally considered part-time workers; and

2. do not provide nonhighly compensated employees with benefits that are relatively close in value to the benefits provided highly compensated employees.

Although we support these policy objectives, we are convinced that the Section 89 tests, as presently structured, are too onerous and that their attendant rules of application are too complex--particularly for small employer group plans. Unless the rules are simplified so that small employers are able to understand, apply and pass the tests, a proliferation of so-called "discriminatory" plans will result.

Furthermore, the objective of expanding coverage to part-time workers must take into account the employee characteristics of small emplcyers and be implemented in a measured, incremental approach to be successful. In contrast, Section 89 artificially imposes a new definition of part-time employee of 17 1/2 hours per week on all employers and requires these employees be counted in Section 89 testing. We find it disturbing that small business owners who have voluntarily taken responsible steps to provide health coverage to full-time employees may now be penalized by Section 89 for failing to cover part-time employees, particularly at a time when Congress has yet to decide on how best to encourage more employers to provide health coverage to full-time employees.

Concerns

The Section 89 nondiscrimination tests and rules, as applied to small employer plans, concern us in several respects:

1. In order to conduct the tests, employers will need to collect and maintain detailed personnel records. These records must identify employees and dependents in a variety of categories (full-time or part-time, eligible or not eligible, insured or not insured, etc.). Few of our 50,000 small employer policyholders presently have data bases sufficient for such purposes.

   We are seeing evidence of confusion and data collection problems in the information sent to us by small employers who request us to test their plans. Although we provide basic work sheets and step-by-step instructions, many of these small employers still have great difficulty sending us the necessary data. Some examples of the types of problems include:

   a. Confusion about which employees and dependents are eligible, covered, excluded or have other coverage.

   b. Failure to identify employees with dependents.

   c. Difficulty identifying "Highly Compensated" employees.

   d. Confusion about designating a test day or test year.

   e. Misconception that all employees counted for testing are required to be covered by the plan.

2. For financial reasons, small employers normally require employees to contribute toward the cost of dependent coverage. Even though the coverage may be available to all employees and the cost may be uniform for all employees, generally the lower paid rank-and-file employees have a greater tendency to elect not to participate because of the expense. This is an affordability problem, not a discrimination issue. As a consequence, small employers will routinely be forced to collect sworn statements from employees and test dependent coverage separately from employee coverage to minimize Section 89 tax penalties. To eliminate this burden, however, many small employers will simply elect to cancel the employer subsidy for dependent coverage. This unintended result could be avoided by removing the current law's participation tests and requiring only uniform availability of dependent coverage.

3. The percentage tests have a disproportionately harsh effect on small groups. When a small employer plan fails the percentage tests because part-time employees (as few as 17 1/2 hours per week) are not eligible for coverage, the employer has four options:

   a. revise the plan's eligibility requirements and attempt to enroll enough part-time employees to satisfy the tests; or

b. reduce the working hours of the part-time employees to less than 17 1/2 hours per week, thus removing those employees from the test base; or

c. leave the plan as is - compute and report the taxable income penalty amounts; or

d. terminate the plan.

Unless additional transitional relief can be obtained to permit an orderly, gradual phase-in of expanded eligibility (i.e., eligibility of part-time employees), the sudden and immediate impact of the cost required to cover these employees will drive many small employers to seriously consider options b., c. and d.--none of which will serve the policy objective of expanded coverage. In fact, we are already beginning to receive requests from policyholders to cancel their group coverage because of both the perceived and actual impact of Section 89.

Suggested Actions

To assure application of the Section 89 nondiscrimination requirements in an orderly, consistent and fair manner, and to further the intent of those requirements without unduly disrupting the existing benefit plan system, we offer the following suggested actions for consideration:

1. Delay application of the tests for at least one year following issue of final regulations. At a bare minimum, the imposition of enforcement penalties should be postponed for this period.

2. Postpone for an additional year (two years following issue of regulations) the testing of plans already subject to other nondiscrimination requirements (e.g., life insurance under Section 79).

3. Phase in health plan testing for all tests (e.g., active full-time employees only in initial year, 20 to 25 hour part-time employees added in second year, 17 1/2 to 20 hour part-time employees added in third year, dependent coverage deemed in compliance if employee coverage passes tests or subject only to uniform availability tests and not participation tests). A phase in for part-time employees for purposes of the 80% test was included in last year's Technical Corrections Act as a result of the efforts of Senator Tom Harkin and Senator Charles Grassley.

The task of collecting data, performing the tests and making plan adjustments will overwhelm many employers. Phasing in some provisions of Section 89 over a period of years will allow employers to educate themselves, develop testing procedures, adjust plan designs and budget for a gradual expansion of eligibility. Phase in will provide employers time to prepare employee educational materials explaining how to complete sworn statements and why they are needed, explaining any needed plan design changes and preparing employees to make informed health plan choices as they become available.

Many employers, particularly small employers, overwhelmed by the complexity of the testing and cost of expanding eligibility will simply choose to ignore Section 89 altogether. Phasing in plans required to test (e.g., employee only coverage the initial year, dependent coverage testing added in subsequent years) and phasing in an expansion of countable employees for test purposes (e.g., active full-time employees only the initial year, 20 to 25 hour part-time employees added in the second year, 17 1/2 to 20 hour part-time employees added in the third year) would make Section 89 a more manageable task.

4. Provide a "safe harbor," plan design whereby a plan would be deemed to pass the nondiscrimination tests:

   a. if a single common schedule of benefits were made available to all employees (nonhighly compensated and highly compensated) and their dependents; and

   b. if all nonhighly compensated employees (less any excludible persons) were eligible for coverage; and

   c. if the employer's contributions to the cost of coverage were the same amount for each employee and dependent unit (except that, as provided under current Section 89 language, employer contributions could be adjusted for part-time employees).

Additional Considerations

The Section 89 tests and rules as presently structured will do little to expand coverage and may, in fact, result in loss of coverage - particularly with respect to benefit plans sponsored by small employers. Should Section 89 remain as is, many small employers will fail the nondiscrimination tests (as confirmed by survey results presented in our July 1988 statement submitted to the Senate Finance Committee hearing on Technical Corrections). Our survey showed that almost half of the small employer failures resulted from failure to enroll part-time employees. Small employer sponsors of those plans that fail because part-time employees are not enrolled have three viable options other than terminating their plan:

1. report the value of employer provided benefit as income to the highly compensated employees thereby generating a revenue increase, but not furthering the expansion of coverage goal; or

2. revise eligibility and enroll those part-time employees required to pass the tests which negates the tax on highly compensated employees and affords the employer an additional tax deduction based on increased amounts contributed to the cost of part-time employee coverage. While coverage is expanded to previously uninsured persons, revenue is lost; or

3. eliminate part-time positions or exclude part-time employees from testing by reducing their work hours to less than 17 1/2 per week. This results in loss of revenue from tax penalties on the highly compensated, failure to expand coverage to the uninsured, and as the unemployed and underemployed increase, tax revenue will be further reduced in proportion to loss of wages.

Small employers would undoubtedly weigh these options from the perspective of their own economic circumstances. Election of option one would not expand coverage. Yet, it is a mistake to assume that those plans that fail the tests will generate significant revenue through tax penalties. Significant revenue would not be raised by the one or two highly compensated employees in a small organization.

Some small employers might choose option two. However, it is also a mistake to assume that expansion of coverage to part-time employees is an economic possibility for most small employers. While coverage might be somewhat expanded, revenue loss associated with increased employer tax deductions might well exceed the revenue gain from employers who elect to pay the tax penalty.

Finally, it is not unreasonable to assume that many small employers, to avoid the tax penalty and the cost of coverage expansion, will choose option three. Option three accomplishes neither increases in revenue nor expansion in coverage. The price of this option in terms of lost/reduced wages and attendant revenue loss is difficult to assess.

The modification we proposed as a small group safe harbor can also be associated with a loss in revenue. Highly compensated employees in plans that otherwise might fail Section 89 could escape the tax penalties by virtue of the safe harbor. However, the advantages of allowing small employers to satisfy Section 89 by virtue of plan design rather than complicated testing far outweighs the disadvantages. The small group safe harbor presents a reasonable middle ground that would promote modest coverage expansion through availability of benefits and a less costly alternative than eliminating or reducing the hours of part-time employees. Most importantly, it allows the small employer to avoid the costly and time consuming task of applying the complex Section 89 tests. The small loss in tax revenue from highly compensated employees by virtue of the small group safe harbor must be weighed against the greater loss of tax revenue, loss of wages and failure to expand coverage.

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